MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

BOARD OF INVESTMENT TRUSTEES: ADMINISTRATIVE MANAGEMENT PRACTICES

PERFORMANCE AUDIT REPORT

MARCH 2004

MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

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LIST OF ABBREVIATIONS

AIMR Association of Investment Management and Research

BIT Board of Investment Trustees

CAFR Comprehensive Annual Financial Report

CAO Chief Administrative Officer
COLA Cost of Living Adjustment
DCP Deferred Compensation Plan

ERISA Employees Retirement and Income Security Act

ERS Employees' Retirement System

FAMIS Financial Accounting and Management Information System

FTE Full-time Equivalents

FY Fiscal Year

GAGAS Generally Accepted Government Auditing Standards

GAO General Accounting Office

GASB Government Accounting Standards Board GFOA Government Finance Officers Association

IRS Internal Revenue Service
IT Information Technology
MCC Montgomery County Code

MD&A Management Discussion and Analysis

NDA Non-Departmental Accounts
OHR Office of Human Resources

OMB Montgomery County Office of Management and Budget

ROI Return on Investment RSP Retirement Savings Plan

SAS Statements on Auditing Standards
SEC Securities and Exchange Commission

TPA Third-Party Administrator

UAAL Unfunded Actuarial Accrued Liability

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SUMMARY

Purpose and Scope of the Audit

This audit was performed as an outgrowth of an investigation into alleged financial improprieties on the part of the former director of pension investments, who was employed by the County between 1995 and 2002, and as a part of our four-year work plan. We performed our audit in accordance with generally accepted government auditing standards and as such we included procedures we considered necessary in the circumstances. This report describes and analyzes the Board of Investment Trustees (BIT) administrative management practices with respect to performance measures, fixed assets management (office equipment and computers), budget practices and administrative expense management, governance and management controls, and follow-up from prior audits. The final issue area deals with the results of our fraud, waste, and abuse investigation.

The audit period includes the fiscal years 1998 through 2002 (July 1, 1997 through June 30, 2002) except where we have incorporated into some tables and accompanying text audited financial information from FY 2003 that recently became available.

This report was not intended to address investment activities of the BIT or its managers. During our planning for this audit nothing about those activities came to our attention that in our judgment required further work by us in that area.

Background

The BIT is responsible for the trust funds of the employees' pension system. At June 30, 2003 the BIT had nearly \$2.0 billion under management in three retirement plans: the Employees' Retirement System (ERS), Retirement Savings Plan (RSP), and Deferred Compensation Plan (DCP). There are more than 18,000 members (ERS and RSP) or participants (DCP) in the three retirement plans. (**Table 1.**)

Table 1.	Selected Variables								
	(FY 2003)								
Variable	ERS	RSP	DCP						
Assets held in trust ¹ /	\$1,726,543,279	\$ 40,214,719	\$ 199,590,622						
Employer contributions	\$ 55,205,855	\$ 6,798,553	N/A						
Employee contributions	\$ 14,769,579	\$ 3,750,518	\$ 21,062,049						
Benefits and refunds	\$ 101,119,443	\$ 866,588	\$ 11,104,092						
Net investment income	\$ 82,174,496	\$ 1,966,730	\$ 4,659,572						
Administrative expenses	\$ 2,007,326	\$ 210,398	\$ 16,967						
Investment expenses	\$ 7,764,561	\$ 32,206	N/A						
Members/participants ¹ /	10,620	3,206	4,841						

Source: OIG analysis of BIT data.

Results in Brief

Our report contains 24 findings and recommendations. We developed findings and recommendations in each of the six audit and investigative topic areas. In the performance measures area, we recommend improvements in reporting bench-marking efforts regarding administrative management practices (Section 2.1, p. 15). In fixed assets management, we recommend actions to enhance accountability for acquisition, safe-keeping, and disposal of office equipment and computers (Section 2.2, p. 22). In budget practices and administrative expense management, we make several recommendations designed to strengthen the BIT budget approval process, reduce administrative expenses in general, and establish a consistent methodology for allocating expenses among retirement plans (Section 2.3, p. 27). In the governance and management controls area we make a number of recommendations designed to increase independence, accountability, and transparency of BIT operations (Section 2.4, p. 44). In the follow-up from prior audits area we make recommendations for the establishment of an audit committee and an audit and compliance review program (Section 2.5, p. 59). In the fraud, waste, and abuse section, we identify questionable activities of a former employee and recommend ways to prevent and detect future instances of fraud, waste, and abuse (Section 2.6, p. 65). We also referred certain activities of the former employee to the State's Attorney's Office.

In addition to improving governance and management controls, our recommendations for corrective action will have a significant fiscal impact. When fully implemented the corrective actions should result in a one time recouping of \$147,973 from past instances of fraud, waste, and abuse; annual savings of \$115,620 attributed to reductions in staff and data services; and additional savings of \$292,402 over the next five years as a result of reduced lease payments for office space. In addition there are significant potential savings from greater restraint regarding future administrative expenditures. Since the beginning of our audit the BIT has reported taking corrective action in many areas.

Management has concurred with one, concurred in part with nine, and did not concur with 13 of our findings and recommendations. Major findings include the following:

^{1/} "Assets held in trust" and "members/participants" numbers are as of June 30, 2003 except the "members/participants" number for the DCP, which is as of June 12, 2003.

- Equipment purchased with trust funds and located in BIT's four-person office included nine laptop computers, seven desktop computers, 10 computer monitors (including five flat screen monitors purchased at the same time), five printers, two fax machines, five personal digital assistants, and three television sets. While some of the equipment may have been obsolete, much of it was not. We recommend enhanced record-keeping and oversight of equipment purchases. (Findings Nos. 2 and 3, pp. 23 and 25)
- Administrative expenditures using trust funds for BIT and non-BIT (County) activities have increased at a rate exceeding that for all County government. We recommend reducing the base for those expenditures by \$334,586 and keeping the rate of future increases at or below the rate for overall County expenditures. We also recommend asking the County to study the possibility of outsourcing more retirement plan administration activities. (Findings Nos. 5 and 10, pp. 34 and 43)
- Salary and benefit costs over five years of \$3.3 million for 30 County employees (11.6 work years) were paid from trust funds. While much of the work undertaken was for legitimate trust purposes, adequate documentation to accurately support payment is lacking. We recommend the development of suitable cost allocation methodologies to clearly document the appropriateness of future payments. (Finding No. 6, p. 36)
- Two of the current four staff positions are not necessary for the efficient operation of BIT. The board has already begun staff reorganization. We recommend reducing BIT personnel costs by \$99,000 annually. (Finding No. 7, p. 39)
- Office space leased by the BIT is excessive according to County space allocation guidelines. While the BIT is working to ensure that a co-tenant pays its fair share, this does not completely solve the problem. We recommend reducing remaining lease payments by \$292,402 and making the trust whole by recouping \$28,819 from the co-tenant and \$67,389 from the County. (Finding No. 8, p. 40)
- The BIT was paying for two subscriptions to a data information service. While the board has authorized the cancellation of one subscription, implementation has not been finalized. We recommend annual savings of \$16,620 by ensuring the cancellation is completed. (Finding No. 9, p. 43)
- The former director of pension investments, who was employed by the County between 1995 and 2002, made improper use of a County credit card, received excessive educational expenses, and failed to reimburse the trust for improper personal expenses. The BIT has already received a substantial portion of the reimbursement. We recommend the trust be made whole by recouping \$51,765 from the former director of pension investments. (Findings Nos. 20, 21, and 22, pp. 66, 69, and 70)

Other findings and recommendations focused on strengthening independence, accountability, and transparency for the BIT and its operations: increasing the number of independent trustees; establishing an audit committee and audit and compliance review program; reorganizing staff functions; establishing a more effective benchmarking effort; requiring the prompt transmittal of all trust funds; ensuring compliance with the County's ethics law; improving contract administration; ensuring adequate supervision of employees; strengthening oversight of the budget process; and ensuring generally accepted government auditing standards are followed in the preparation and auditing of financial statements.

Summary of Findings

	mary or Findings		Council	
			Action	Agency
No.	Title of Finding	Page	Required	Response
	Performance Measures			
1.	Establish Benchmarks to Measure Administrative	19	No	Concur In
	Management Practices			Part
	Fixed Assets Management			
2.	Strengthen Fixed Assets Record-Keeping	23	No	Do Not
				Concur
3.	Strengthen Oversight of Equipment Purchases and	25	No	Do Not
	Disposals			Concur
	Budget Practices and Administrative Expension	se Mana		
4.	Strengthen Oversight of Budget Process	30	Yes	Do Not
				Concur
5.	Reduce Administrative Expenditures	34	No	Do Not
				Concur
6.	Establish Methodology to Support Non-BIT Employee	36	No	Do Not
	Costs			Concur
7.	Reduce BIT Staff	39	No	Concur In
				Part
8.	Reduce Real Property Lease Payments	40	No	Concur In
				Part
9.	Reduce Payments for Data Service	43	No	Concur In
				Part
10.	Study Further Outsourcing of Plan Administration	43	No	Do Not
	Activities			Concur
	Governance and Management Co		T	ı
11.	Seek Increase in Number of Independent Trustees	46	Yes	
12.	Require Prompt Transmittal of All Trust Funds	49	No	Do Not
				Concur
13.	Seek Greater Trustee Responsibility for Staff and	51	Yes	Do Not
	Consultants			Concur
14.	Acquire the Services of a Full-Time Staff Accountant	52	No	Concur In
				Part

			Council	
No.	Title of Finding	Page	Action Required	Agency Response
15.	Improve Staff Responsibility for Contract	54	No	Do Not
13.	Administration	34	110	Concur
16.	Ensure Government Auditing Standards are Followed	55	No	Do Not
				Concur
17.	Exercise Reasonable Care in Preparation of CAFR	58	No	Do Not
				Concur
	Follow-up from Prior Audits	5		
18.	Establish an Independent Audit Committee	60	No	Do Not
				Concur
19.	Establish Regular Audit and Compliance Review	63	No	Do Not
	Program			Concur
	Fraud, Waste, and Abuse Investig	ation		
20.	Ensure Reimbursement for Improper Credit Card	66	No	Concur In
	Expenses			Part
21.	Ensure Reimbursement for Excessive Educational	69	No	Concur In
	Expenses			Part
22.	Ensure Reimbursement for Improper Personal	70	No	Concur In
	Expenses			Part
23.	Ensure Compliance with County Ethics Law	72	No	Concur
24.	Ensure Due Diligence and Supervision of Employees	72	No	Concur In
				Part

Report Outline

The following sections of this report present our analysis of BIT administrative management practices with regard to performance measures, fixed assets management (office equipment and computers), budget practices and administrative expense management, governance and management controls, follow-up from prior audits, and the results of our fraud, waste, and abuse investigation. **Chapter 1** contains an introduction with background information on BIT programs, organization, and financial and operating results. It also includes a section on significant achievements of the BIT. **Chapter 2** contains our findings and recommendations as well as the BIT responses grouped into sub-chapters on performance measures, fixed assets management (office equipment and computers), budget practices and administrative expense management, governance and management controls, follow-up from prior audits, and the results of our fraud, waste, and abuse investigation. **Chapter 3** discusses one "other issue and concern" we noted during the course of our audit. **Chapter 4** contains our conclusions.

MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

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MARCH 2004

1. INTRODUCTION

This chapter contains the scope, objectives, and methodology of the audit; background information about the Montgomery County Board of Investment Trustees (BIT) including information on the three employee retirement plans it offers; how it is organized, financial information related to its programs and operations, and BIT significant achievements. The purpose of this chapter is to provide readers with some context before discussing findings and recommendations in chapter 2, an "issue and concern" in chapter 3, and our conclusions in chapter 4.

1.1 Scope, Objectives, and Methodology

We performed our audit of BIT administrative management practices in accordance with <u>Government Auditing Standards</u> issued by the Comptroller General of the United States. Our investigation of certain activities of the former director of pension investments was conducted in accordance with <u>Quality Standards for Investigations</u> issued by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. Accordingly, we included such procedures as we considered necessary in the circumstances. An audit also includes an assessment of management controls when necessary to satisfy audit objectives. We believe our audit provides a reasonable basis for our findings, recommendations, and conclusions.

1.1.1 Scope and Objectives

This report describes and analyzes the administrative management practices of the BIT for the five-year period July 1, 1997 through June 30, 2002 except where we have incorporated into some tables and accompanying text audited financial information from FY 2003 that recently became available. A few other issues occurring either before or after that time-frame have also been taken into account.

This report does not address and was not intended to address investment activities of the BIT or its investment managers. During our planning for this audit nothing about those activities came to our attention that in our judgment required further work by us in that area.

We focused on issues related to the administrative management practices of the BIT and its trust funds as those practices affected the operations of the three employee retirement plans. Our focus addressed the following specific objectives:

- to evaluate the adequacy and reliability of some BIT administrative management performance measures;
- to examine the efficiency and effectiveness of fixed assets management (office equipment and computers);
- to review the efficiency and effectiveness of budget practices and administrative expense management;
- to evaluate the effectiveness of governance and management controls;
- to review the effectiveness of follow-up on and implementation of recommendations from prior audits and other evaluations, and
- to investigate and report on allegations of fraud, waste, and abuse.

1.1.2 Methodology

To obtain general background information and to develop an understanding of employee retirement programs, we reviewed audits, reports, and articles published by the federal government, professionally-recognized associations, and non-governmental organizations.

In designing the methodology for our audit we used three basic approaches to obtain back-ground information. First, we conducted 15 structured planning interviews as follows: current and former trustees (10), current and former managers and supervisors (3), and rank-and-file employees (2). Second, we sent management controls surveys to current and former trustees and employees (47) and analyzed the responses we received (21). Third, we reviewed pertinent sections of Chapter 33 of the County Code and legislative histories relating to the governance of employee retirement plans, BIT governance documents including by-laws, administrative policies, travel guidelines, vendor procurement policy, manager funding policy, investment policies, derivatives policy, risk management policy, and rebalancing policy. We also reviewed board minutes, organization charts, financial reports and budgets, contracts and lease documents, as well as several feasibility, consultant, and management reports.

To obtain information necessary for us to achieve our audit objectives, we used standard methods – document and file reviews, structured interviews, fieldwork sampling and testing, and descriptive analysis. We interviewed BIT and County officials and employees and reviewed and analyzed revenues, expenditures, operational data, employee job descriptions, and financial disclosure statements. We compared BIT programs and operations with other

similar jurisdictions and with industry norms. We also contracted with a consulting audit firm to review management controls and accounts payable.

1.2 Background

The BIT was created by County Council in 1987 to manage the trust funds established for the benefit of the employees of County government or of a participating agency or political sub-division who are contributing to one of the three employee retirement plans. With few exceptions, all full-time County employees must become members of a retirement plan; part-time employees and elected officials have the option of choosing a plan.

The BIT trust or trusts consist of all money and property of the three employee retirement plans and all earnings and other additions thereto. The BIT has legal title to all cash and other property of the three employee retirement plans. The BIT is primarily engaged in the investment of all trust funds, while the County is primarily engaged in plan administration activities.

A legal description of the BIT and its three employee retirement plans can be found in various parts of chapter 33 of the Montgomery County Code.

1.2.1 Employee Retirement Plans

Montgomery County's three employee retirement plans are as follows: the Employees' Retirement System (ERS), the Retirement Savings Plan (RSP), and the Deferred Compensation Plan (DCP). The combined funds in each of the plans make up the entity we will refer to in this report as the BIT trust. However, each plan is itself a separate and distinct trust.

<u>The ERS</u> is a defined benefit retirement plan established in 1965. Active members contribute from four percent to 8.5 percent of their regular earnings up to the Social Security wage base with an additional amount after that. The County and each participating agency or political sub-division contributes additional amounts necessary to make the plan actuarially sound. All benefits vest after five years of service. The normal retirement benefit is an annuity of between two and 2.5 percent for each year of credited service. The ERS provides options for disability and death benefits. Annual cost-of-living adjustments are provided to retirees and beneficiaries.

The BIT contracts with 12 investment managers who actively manage ERS funds based on an allocation strategy established by the BIT. The County contracts with third-parties for benefits payments and record-keeping.

At June 30, 2003 there were 10,620 ERS members as follows: active plan members (5,876), inactive plan members who are vested (374), retirees and beneficiaries receiving benefits (4,370). The ERS is closed to all County employees hired after 1994 except fire and police. Public safety employees have the irrevocable option of joining either the ERS or RSP.

The RSP is a defined contribution retirement plan subject to §401(a) of the Internal Revenue Code. The RSP was established in 1994. Active members contribute three percent of their regular earnings up to the maximum Social Security wage base and six percent above that level. The County and each participating agency or political sub-division contributes an additional six percent of regular earnings for non-public safety employees and ten percent for public safety employees. Employee contributions vest immediately and employer contributions vest after three years of service. RSP members invest their own funds by choosing from a menu of 24 investment options available from a single service provider. The BIT contracts with a third-party for investment management advice, benefits payments, and record-keeping. At June 30, 2003 there were 3,206 RSP members.

<u>The DCP</u>, for which the BIT assumed administrative responsibility in 1999, is a plan available to County employees in addition to either the ERS or RSP described above. The DCP, authorized under §457 of the Internal Revenue Code, currently allows employees to set aside up to \$12,000 of their regular compensation each year and thereby defer paying taxes on that amount to a later time, generally during retirement, when their taxable incomes may be significantly reduced. The allowable amount that may be deferred in any one year will rise to \$15,000 in 2007 and thereafter be indexed for inflation. There are also higher "catchup" amounts that may be deferred by older employees. There are no employer contributions in this plan.

DCP participants choose to invest the money in their accounts in any one of several different investment vehicles available. The BIT contracts with two service providers for investment management advice, benefits payments, and record-keeping. At June 12, 2003 there were approximately 4,841 DCP participants. (**Table 2.**)

Table 2.	Members/Participants (FY 1998 – FY 2003)								
Plan	1998 1999 2000 2001 2002 2003								
ERS									
Active	6,424	6,225	6,094	6,024	5,989	5,876			
Inactive	218	297	302	390	427	374			
Retirees	3,585	3,735	3,869	3,989	4,115	4,370			
RSP	1,043	1,510	2,544	2,536	2,908	3,206			
DCP	N/A	N/A	N/A	N/A	N/A	4,8411			

Source: OIG analysis of BIT data.

1.2.2 Organization

The BIT has nine voting members all of whom are appointed by the County Executive and confirmed by the County Council. Four trustees are ex-officio members of the board: the staff director of the County Council, the director of human resources, the director of management and budget, and the director of finance. Of the five remaining trustees, one must be an active County employee in a collective bargaining unit who is a vested member

¹/₂ At June 12, 2003. Information was not readily available for prior years.

of the retirement system; one must be a merit system employee who is a vested member of the retirement system and not a member of a collective bargaining unit; one must be a retired County employee who is a member of the retirement system; one must be a representative of the County Council chosen from a list recommended by the County Council; and one must be an individual knowledgeable in pensions, investments, or other financial matters.

Employee and retired members from participating agencies and political sub-divisions are not guaranteed any direct representation on the BIT. Participating agencies and political sub-divisions include: Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, independent fire/rescue corporations, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland.

The BIT has adopted written by-laws which it has amended from time to time. The by-laws require the trustees to meet at least quarterly. The by-laws also provide for two three-member standing committees: administration and investments, which meet between BIT quarterly meetings. A quorum for BIT meetings is five (5) members.

The BIT has no full-time or part-time employees of its own. Four full-time County employees: an executive director (formerly known as director of pension investments), a senior investment officer, a program specialist, and a principal administrative aide, all appointed by and reporting to the County's chief administrative officer, assist the BIT with daily operations. In addition the BIT has contracted with a consultant to advise the board on matters relating to the recruitment, retention, compensation, and evaluation of 12 investment managers involved with ERS funds. The BIT also has a contractual relationship with five firms to provide the board and County with an array of services including benefits payments, investment education, financial information, record-keeping, and investment advisory services for RSP and DCP funds.

The County appoints and manages the following on behalf of the BIT: the custodial bank, the actuary, and the independent auditor. The County also provides the BIT with legal services, internal auditing services, retirement administration, and accounting services. Those services are provided by 30 County employees billing the equivalent of 11.6 work years.

1.2.3 Plan Assets, Contributions, Benefits, Income, and Expenses

Total assets held in trust by the BIT for the three employee retirement plans <u>average</u> more than \$2 billion annually. The ERS is the largest employee retirement plan with <u>average</u> assets of more than \$1.8 billion (89.7) percent), followed by the DCP with \$186.7 million (9.2 percent), and the RSP with \$22.3 million (1.1 percent). (**Table 3.**)

Table 3.	Net Assets Held in Trust (At June 30)									
		(in millions of dollars)								
Plan	1998	1999	2000	2001	2002	2003	Average			
ERS	1,750.6	1,900.7	2,012.8	1,837.7	1,677.5	1,726.5	1,817.6			
RSP	7.7	12.8	20.4	23.9	28.8	40.2	22.3			
DCP	143.4	179.0	213.5	199.6	185.0	199.6	186.7			
Total	1,901.7	2,092.5	2,246.7	2,061.2	1,891.3	1,966.3	2,026.6			

Source: OIG analysis of BIT data.

Average annual contributions to the three employee retirement plans amount to \$83.1 million. Of that amount \$51.1 million comes from employers and \$32.0 million comes from employees. Approximately \$46.8 million of employer contributions (91.6 percent) go into the ERS with the remaining \$4.3 million (8.4 percent) going into the RSP. There is no employer contribution for the DCP. With respect to employee contributions, \$17.8 million (55.6 percent) goes into the DCP, \$11.8 million (36.9 percent) goes into the ERS, and the remaining \$2.4 million (7.5 percent) goes into the RSP. (**Table 4.**)

Table 4.	Employer and Employee Contributions (FY 1998 – FY 2003)								
		(1	1 1770	1 1 2003)		(in million	s of dollars)		
Plan	1998	1999	2000	2001	2002	2003	Average		
ERS									
Employer	51.1	47.5	44.4	43.4	39.2	55.2	46.8		
Employee	10.5	10.5	10.9	11.3	12.9	14.8	11.8		
RSP									
Employer	1.9	2.6	3.7	4.9	5.8	6.8	4.3		
Employee	.9	1.4	2.1	2.6	3.3	3.8	2.4		
DCP									
Employer 1/2									
Employee	13.7	15.3	18.0	18.6	20.1	21.1	17.8		
Total									
Employer	53.0	50.1	48.1	48.3	45.0	62.0	51.1		
Employee	25.1	27.2	31.0	32.5	36.3	39.7	32.0		

Source: OIG analysis of BIT data.

Annual retiree, disability, and survivor benefits and member/participant refunds paid from the three employee retirement plans <u>averaged</u> over \$86.6 million. The ERS paid out an average of \$78.2 million annually. The more recently established RSP paid out an average annual amount of approximately \$900,000. The DCP paid out an average of \$7.5 million annually over four years. (**Table 5.**)

¹/_{There} is no employer contribution to the DCP.

Table 5.	Benefits and Refunds (FY 1998 - FY 2003)								
	(in millions of dollars)								
Plan	1998	1999	2000	2001	2002	2003	Average		
ERS	63.3	67.1	72.2	79.5	86.0	101.1	78.2		
RSP	.3	.6	.9	1.5	.9	.9	.9		
DCP	N/A	N/A	4.0	4.8	9.9	11.1	7.5		
Total	63.6	67.7	77.1	85.8	96.8	113.1	86.6		

Source: OIG analysis of BIT data.

Over the six year period FY 1998 – FY 2003 the BIT earned a combined total of \$535.2 million for the three employee retirement programs. After deducting investment expenses, net income was \$467.7 million. Most of the net income (\$448.6 million) was recorded in the ERS; while the DCP earned \$17.5 million for the period and the RSP recorded net income of \$1.6 million for the six years. (**Table 6.**)

We note that the BIT is not as directly involved in RSP and DCP investment decisions as it is with the ERS. Its role with respect to RSP and DCP investment decisions is limited to choosing service providers and investment options for members or participants. Also, given the volatility of financial markets during the period, the use of averages can be misleading. For example, between FY 1998 and FY 2000 the three employee retirement plans had net income of \$643.3 million distributed among the plans as follows: ERS, \$572.0 million; RSP, \$5.2 million; and DCP, \$66.1 million. However, following those gains the plans lost a total of \$264.4 million in FY 2001 and FY 2002: the ERS lost \$205.6 million; the RSP \$5.6 million; and the DCP \$53.2 million. In FY 2003 as the stock market improved, the three plans posted combined net income of \$88.8 million: \$82.2 million for the ERS; \$2.0 million for the RSP; and \$4.6 million for the DCP. (**Table 6.**)

Table 6.	Net Investment Income (FY 1998 – FY 2003)									
					(in millions	of dollars)			
Plan	1998	1999	2000	2001	2002	2003	Total			
ERS	271.0	165.7	135.3	-81.4	-124.2	82.2	448.6			
RSP	0.9	1.6	2.7	-2.4	-3.2	2.0	1.6			
DCP	21.4	24.1	20.6	-27.7	-25.5	4.6	17.5			
Total	293.3	191.4	158.6	-111.5	-152.9	88.8	467.7			

Source: OIG analysis of BIT data.

Administrative expense is one more important area where the BIT has direct involvement and responsibility. While the dollar amounts compared to overall trust assets are small, they are nonetheless important. Between FY 1998 and FY 2003 nearly \$11.7 million was spent for administrative purposes. Of that amount, nearly \$4.5 million (38.1 percent) was spent on BIT operations and more than \$7.2 million (61.9 percent) was spent on County operations to administer the three employee retirement programs. (**Table 7.**)

Table 7.	Administrative Expenses (FY 1998 - FY 2003)									
	(in thousands of dollars)									
Plan	1998	1999	2000	2001	2002	2003	Total			
ERS										
BIT	633	602	342	571	781	681	3,610			
County	806	921	1,149	1,342	1,311	1,327	6,856			
RSP										
BIT	45	88	96	113	127	109	578			
County	5	8	8	11	23	102	157			
DCP										
BIT	N/A	N/A	107	70	18	65	260			
County	N/A	N/A	38	39	32	98	207			
All Plans										
BIT	678	690	545	754	926	855	4,448			
County	811	929	1,195	1,392	1,366	1,527	7,220			
Total	1,489	1,619	1,740	2,146	2,292	2,382	11,668			

Source: OIG analysis of BIT data.

1.3 Significant Achievements

It is important to recognize that performance auditing by its nature is a critical process, designed to identify problems or weaknesses in past and existing practices. We note here three successful and positive practices that we observed and for which sufficient documentation for verification was available.

1.3.1 GFOA Certificate of Achievement

The Government Finance Officers Association (GFOA) awarded the BIT a Certificate of Achievement for Excellence in Financial Reporting for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2002. The certificate of achievement is a prestigious national award which recognizes conformance with the highest standards for preparation of state and local government financial reports. In order to be awarded a certificate a government must publish an easily readable and efficiently organized CAFR whose contents conform to GFOA program standards. Such a report must satisfy generally accepted accounting principles and applicable legal requirements.

The BIT has received the GFOA certificate of achievement for the last three consecutive years, each year for which the BIT has published its own CAFR.

1.3.2 Implementation of GASB Statements 34 and 37

In addition to the certificate of achievement, effective July 1, 2001 the BIT implemented Government Accounting Standards Board (GASB) Statement 34 and Statement 37. The

primary impact of the implementation of these two GASB statements is the addition of a management discussion and analysis (MD&A) section to the BIT annual report. The MD&A provides information that will better enable readers to more readily assess whether the financial positions of the three employee retirement plans have improved or deteriorated as a result of the year's operations.

1.3.3 Investment Portfolio Management

The BIT has reported success in managing the ERS portfolio over the past ten years. Trustees report the average rate of return for the past ten years has exceeded the ERS's eight percent assumed actuarial return. In each of the last ten years overall ERS investment performance has exceeded the Board's annual policy benchmark, or investment return target. Further, according to a national pension consulting firm, BIT investment management fees are lower than the average of its peers. Also, for the year ended June 30, 2003 the BIT reports returns on investment results were higher than 63 percent of public pension funds with like assets under management.

Also, for the RSP and DCP, the BIT reports 39 percent of the fund choices available in the DCP and 44 percent in the RSP are rated as four- or five-star. In contrast, a nationally-recognized mutual fund rating agency rated 29 percent of all available funds as four- and five-star.

MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

BOARD OF INVESTMENT TRUSTEES: ADMINISTRATIVE MANAGEMENT PRACTICES

PERFORMANCE AUDIT REPORT

MARCH 2004

2. FINDINGS AND RECOMMENDATIONS

This chapter contains our 24 findings and recommendations as well as the BIT responses. The information is organized into six sections, each corresponding to an audit objective: performance measures; fixed assets management office equipment and computers); budget practices and administrative expense management; governance and management controls; follow-up from prior audits; and a fraud, waste, and abuse investigation.

2.1 Performance Measures

In this section we evaluate the efficiency and effectiveness of selected performance measures for the Montgomery County Employee Retirement Plans. Our goal in performance measurement is to show meaningful comparisons both over time and among peers. Generally in this process we begin by reviewing program measures a department or office has submitted to OMB's Montgomery Measures Up! or those reported in the County Executive's recommended Operating Budget and Public Services Program. However, no program measures for the BIT are reported in those publications. Therefore, after asking current and former trustees and staff about appropriate performance measures and researching the issue on our own, we settled on several sources: a well-known national consultant used by the BIT who provided us with information regarding total fund returns and fees for the ERS; a survey of state and local government employee retirement systems; and publicly available information we have been able to gather from other organizations.

2.1.1 Effectiveness

With respect to measuring the effectiveness of a retirement plan an appropriate and important outcome measure is "return on investment." The BIT investment consultant provided us with information that compared rates of return for the ERS, the BIT policy index (which changes over time as a result of its asset allocation policy), the median of the consultant's public client universe, and the median of the public fund universe. For the one-year period the ERS rate of return compared favorably with the median of the consultant's public client clients and the public fund universe. For the three-year period the ERS rate of return compared favorably with the median of the public fund universe and the BIT policy index. Over the five- and ten-year periods, the ERS underperformed relative to the other indices shown on Table 8. (**Table 8.**)

	Rates of Return for ERS and Selected Indices (June 30, 2003) (in percent)						
ITEM	5 Year	10 Year					
ERS 1/	4.8	-2.2	2.0	7.9			
BIT Policy Index ²	5.3	-2.9	2.3	8.1			
Consultant's Public Clients 1/	4.2	-0.8	2.9	8.2			
Public Fund Universe 3/	3.9	-2.4	2.6	8.3			

Source: BIT consultant.

We were not able to calculate aggregate rates of return for the RSP and the DCP for the same periods. The RSP and DCP are not defined benefit plans. Member/participants of the plans (who assume total risk for any investment decisions) make their own investment choices from an array of options instead of having their investments actively managed by the BIT as in the case of the ERS. Therefore, any comparison of rates of return for the ERS on the one hand and the RSP and DCP on the other would be a comparison of rates of return achieved by investment managers versus aggregate returns achieved by individual investors. Rates of return for each of the various investment options available to RSP and DCP member/participants for one-, five-, and ten-year periods are available on the BIT web page.

Another generally accepted measure of effectiveness with respect to a defined benefit plan such as the ERS is "funding progress" defined as any unfunded actuarial accrued liability (UAAL) expressed in one of two ways: either as a ratio of actuarial accrued liabilities to the actuarial value of assets or as a percentage of "covered payroll." Covered payroll is defined as the salary or wages earned by employees who are members of ("covered" by) the plan. The idea is to describe the percent of covered payroll in a year that would be needed to eliminate the UAAL. As a general rule, the greater the funded ratio and the smaller the percentage of covered payroll, the stronger the system.

We compared funding progress for the ERS with the defined benefit plans of Fairfax County and the states of Maryland and Virginia and over time. With regard to funded ratios, the ERS had a UAAL in each of the five years of the audit period. A large percentage of the increase was related to plan benefit changes resulting from labor negotiations and declining market conditions. (**Table 9.**)

½ Returns are net of investment expense.

² Policy index changes over time as a result of asset allocation policy.

^{3/} Gross of fees less estimated fees of 40 basis points annually.

Table 9. Funded Ratios for Selected Jurisdictions								
(FY 1998 - FY 2002)								
Jurisdiction 1998 1999 2000 2001 2002								
Montgomery County	90.2	93.9	98.9	94.3	89.6			
Fairfax County	99.2	103.8	100.2	97.3	90.4			
State of Maryland	90.6	97.1	101.2	98.3	94.7			
State of Virginia	87.8	94.9	105.4	107.3	N/A			

Source: OIG analysis of data reported by jurisdictions.

We also looked at UAAL as a percentage of covered payroll. Because of plan benefit changes and declining market conditions the percentage of payroll needed to cover the UAAL increased dramatically between FY 2000 and FY 2002 after declining substantially between FY 1998 and FY 2000. (**Table 10.**)

Table 10. Unfunded Actuarial Accrued Liability as Percentage of Covered Payroll (FY 1998 - FY 2002)								
Jurisdiction 1998 1999 2000 2001 2002								
Montgomery County	58.7	39.5	6.9	41.6	79.4			
Fairfax County	2.7	-14.1	-0.9	10.5	38.9			
State of Maryland	43.0	13.0	-5.0	8.0	23.0			
State of Virginia	41.1	17.7	-18.4	-25.5	N/A			

Source: OIG analysis of data reported by jurisdictions.

Based on the information we reviewed regarding funding progress, we conclude that the ERS compares less favorably with other selected public pension systems and over time with regard to both funded ratios and UAAL as a percentage of covered payroll.

2.1.2 Efficiency

Efficiency is defined as the level of input required to produce or maintain a certain level of output. An organization or program is said to be efficient if it uses the same level of input as in the past to produce or maintain a greater level of output. An organization or program may also be said to efficient if it reduces its input while still producing or maintaining the same level of output. In measuring the efficiency of BIT programs and operations we chose to look at two variables: administrative expense and investment expense. The output part of our equation was the average assets held in trust. Efficiency for BIT retirement programs and operations is expressed in terms of basis points. One percent equals 100 basis points.

The following tables depict administrative expense and investment expense efficiency during the six-year period FY 1998 – FY 2003. (Fewer basis points denote greater efficiency.) (**Tables 11 and 12.**)

Table 11. Administrative Expense Efficiency (FY 1998 - FY 2003) (basis points)							
Plan	1998	1999	2000	2001	2002	2003	
ERS	7.3	7.1	6.2	8.9	11.9	11.8	
RSP	82.3	41.5	25.4	22.3	33.2	61.0	
DCP	N/A	N/A	2.9	3.0	2.5	0.9	

Source: OIG analysis of BIT data.

Table 12.	. Investment Expense Efficiency (FY 1998 - FY 2003) (basis points)						
Plan	1998	1999	2000	2001	2002	2003	
ERS	N/A	N/A	31.6	34.2	32.2	30.7	
RSP	173.3	123.5	85.2	113.3	81.3	9.4	
DCP	N/A	N/A	N/A	N/A	N/A	N/A	

Source: OIG analysis of BIT data.

We were able to compare the BIT program with retirement programs from the three other local jurisdictions mentioned above: Fairfax County and the states of Maryland and Virginia for FY 2000 only. The information we used for this comparison was obtained from a 2001 survey of state and local government employee retirement systems compiled by the Public Pension Coordinating Committee. The information was self-reported by the jurisdictions surveyed and was the most recent and most readily available comparative data on the subject that we could find. This comparative data showed the BIT programs to be less efficient than the programs from the other three jurisdictions regarding both investment expenses and administrative expenses. (Fewer basis points denote greater efficiency.) (Table 13.)

Table 13. Comparative Efficiency Measures (FY 2000)							
Jurisdiction	(basis points) Total Expense Efficiency						
Montgomery County	30.0	5.9	35.9				
Fairfax County	26.4	4.1	30.5				
State of Maryland	18.5	6.0	24.5				
State of Virginia	25.7	4.5	30.2				

Source: OIG analysis of national survey data.

Additionally, a BIT consultant provided us with information regarding administrative and investment expenses for the ERS and other public programs for FY 2002. The information was contained in a report done by a third party expert and showed the ERS to be slightly more efficient than the aggregate of the other public programs in the report: total fees (both investment and administrative fees) were 43.5 basis points for public funds and 40.7 basis points for the ERS.

The following section 2.1.3 contains our finding and recommendation as well as the BIT response regarding performance measures.

2.1.3 Establish Benchmarks to Measure Administrative Management Practices (Finding No. 1)

The BIT has not benchmarked the performance of administrative management practices with peers and over time in a format readily accessible to its stakeholders. When we interviewed current and former trustees and senior staff, under conditions of confidentiality where the persons being interviewed could speak freely, one of the questions we asked was: How would you measure BIT performance? What measures would you use? The following are answers we were given:

- Efficiency: ratio of expenses to plan assets. Effectiveness: relationships to policies BIT has established; compare with peers. [Respondent] thinks BIT does well.
- First, comparison with peers and comparisons over time. [Consultant] maintains data file. Second, costs as percentage of assets; expense ratios.
- Ultimately investment performance. There are standards for comparison; both to market and to peers. Peers would be public pension funds of comparable size. Also, ratio of administrative fees to size of program.
- Measures of expense ratios ([consultant] is a good source).
- Comparison to peers (possibly Fairfax Co.).
- Adherence to budgets, no excess spending; ROI.
- Check resources used; # payroll, # personnel, # resources, etc. [Consultant] and custodial bank could provide help here. What is rate of return? What is investment performance? Compare with peers: Fairfax, DC.

Those answers strongly suggest to us that current and former trustees and staff believe measuring both administrative management practices and investment performance is important.

The County has a vigorous and growing performance measurement effort. Improved program measurement with its emphasis on reporting results is a long-term goal of the County. While the BIT maintains data on the performance of some aspects of its programs, it reports very little about administrative management practices in a comparative format that can be easily understood by stakeholders. It is an important component of accountability that the BIT should not only report what is being done with respect to administrative management practices, but also how well it is being done. For example each BIT program should

report regular, critical evaluations of performance as compared to peers and over time in areas such as administrative and investment expenses.

In our peer comparisons we used Fairfax County and the states of Maryland and Virginia for illustrative purposes. The BIT has suggested there are other more appropriate peers for comparison. That is quite possibly true. We understand administrative management practices may vary among jurisdictions and over time, but despite these variations we believe it is possible to select a peer group of public pension systems for comparability. We hope the BIT will identify them and provide the appropriate comparisons.

The annual financial report of BIT provides a statistical section. However, while the information contained therein is valuable, it does not include very much in the way of comparative performance measurement regarding administrative management practices with peer jurisdictions or over time. The GFOA recently issued a statement recommending the use of comparative data over time and with other similar governments for the benefit of government officials and other interested parties who wish to use financial data from the CAFR to analyze a government program's financial health. We believe the GFOA statement supports our position.

Management controls are designed to reasonably ensure programs achieve their intended results and require the development of timely and reliable information for decision-making. Comparative information is crucial to help plan members/participants, plan administrators, taxpayers, and other interested parties evaluate the relative performance of the plan. This information can play a crucial role in helping to plan future strategies for the BIT.

Recommendation:

The BIT should identify four or five peer jurisdictions and include comparable performance measures and benchmarking information regarding administrative management practices in its annual report, Montgomery Measures Up!, the County Executive's Recommended Operating Budget and Public Services Program, or other similarly suitable publications. At a minimum this benchmarking effort should include for BIT and the peers it has identified information on such things as rates of return, administrative and investment expenses, and funding progress.

Agency Response:

We concur in part. The Board supports benchmarking its performance in various areas and has consistently done so. But the Board uses industry standards – as OIG does in benchmarking its own performance – not the "four or five peer jurisdictions" approach that OIG suggests here. That approach compares apples and oranges and is flawed. OIG's unsuccessful attempts in this section to assess the "effectiveness" and "efficiency" of the ERS and three other plans confirm this point.

The Board regularly submits information to national consulting firms that compile databases and issue reports on various aspects of retirement plan management. For example,

one national firm reported that the ERS' 25.5% net investment return for calendar year 2003 was in the top 10% of similar pension funds. Another national firm reported that the ERS' administrative expenses in FY 2002 were nearly 10% below those of similar pension funds. In addition, the Government Finance Officers Association (GFOA) has awarded the Board its prestigious Certificate of Achievement for Excellence in Financial Reporting for all three years for which the Board has published its own Comprehensive Annual Financial Report (CAFR).

OIG has also seen our consultant's extensive quarterly reports on investment performance and their annual report that rates all three retirement plans against detailed criteria for highly effective operations. The Board's web site displays the investment performance for all three plans, along with all the Board's investment policies and guidelines and extensive additional data. Our web site also includes the CAFR, which has an investment section highlighting the performance of each asset class and individual investment manager, and aggregate risk and return data from our consultant's universe of public funds.

By contrast, in sections 2.2.2 and 2.2.3 OIG presents an inaccurate analysis of the ERS' "effectiveness" and "efficiency." OIG fails to understand that to make valid comparisons among pension plans, you need to use valid industry standards over time. In addition, you can accurately compare plans only if they have the same benefit structure, actuarial assumptions and methodologies, and investment objectives.

That is why OIG's attempts to compare the ERS with just three nearby funds — one of the three Fairfax plans and the huge Maryland and Virginia state plans — are flawed. The ERS is a partially frozen plan; since October 1, 1994, general government employees have not been able to enter it. Since its time horizon is shorter, its funding assumptions and investment objectives differ from those of the other plans, which are not frozen. In addition, the ERS includes a Deferred Retirement Option Program (DROP), which the Fairfax plan does not. There are also specific differences in investment objectives, including the extent to which venture capital, leveraged buyouts, and hedge funds are used. (Until December 1998 County law limited the ERS' investment options.) Fee comparisons are hard to make because the state funds, with huge assets, can benefit from the sliding fee scale used by most investment managers. Similarly, some administrative fees have fixed rather than proportional costs.

OIG's review of the "funding progress" of the ERS, compared to the three other area plans in tables 9 and 10, is also inaccurate. OIG's conclusion – that the ERS lags the other plans – fails to reflect the fact that relative to the other funds, given roughly similar investment results over time, the ERS' "funding progress" has been determined by one factor alone: the large pension improvements mandated by County collective bargaining agreements in recent years. As OIG knows, the Board is not a decision-maker on collective bargaining or on benefit levels.

Benchmarking in this field requires that you use valid industry standards and compare apples with apples. OIG's performance calculations and efficiency measures are incorrect. Are the Montgomery County retirement plans less "efficient" because we elected to comply

with GASB #34 and incurred greater auditing costs than other plans? Is the ERS less "efficient" because we have succeeded in boosting returns by relying less on passive investment managers (who charge lower fees) than some funds do and more on first-rate active managers?

OIG asserts that GFOA supports its position on benchmarking. We disagree. We also believe that OIG's use of excerpts from "confidential" interviews with trustees, where the question, respondent, and context are unclear, adds no value.

The Board will include Montgomery Measures Up! in its work on benchmarking. (We should note that the very limited amount of benchmarking in that volume – as opposed to reports of County data alone – is based on industry standards, not on OIG's "four or five peer jurisdictions" approach.) The Board will continue to measure performance the right way in order to inform the community, not mislead it.

2.2 Fixed Assets Management

In this section we evaluate the efficiency and effectiveness of fixed assets management. Fixed assets are all tangible assets with a service life of more than one year that are used in the operation of the business and were not acquired for resale. In the past these assets were often referred to as "property, plant, and equipment." Fixed assets for the BIT consist primarily of such things as computers and furniture purchased with trust funds. They do not include retirement plan investments. County policy regarding fixed assets management requires fixed assets costing \$5,000 or more must be accounted for in the appropriate financial statements while those costing less than \$5,000 are subject to appropriate management control. Certain assets must be reported to Finance annually, while detailed individual schedules of other assets are required to be kept by office or department management. The BIT has not fully complied with these procedures.

The BIT is exempt from County procurement laws and regulations for the purchase of both goods and services. The County's procurement laws and regulations are important management controls that help ensure the proper stewardship of assets. Stewardship requires accountability. We can understand how it might be inefficient to require the BIT to follow County procurement regulations for the purchase of professional services such as investment managers. In fact the BIT has in place a process for selecting such professional services that seems to us to be reasonably prudent and accountable. Being exempt from County policies for the purchase of investment management services seems to us to serve a legitimate purpose; however, being exempt for the purchase of goods has been problematic. Adherence to procurement regulations might have prevented the wasteful purchase of some office equipment.

The following sections 2.2.1 and 2.2.2 contain our findings and recommendations as well as BIT responses regarding fixed assets management.

2.2.1 Strengthen Fixed Assets Record-Keeping

(Finding No. 2)

At the time we began our audit BIT staff had not conducted an annual physical inspection and confirmation of assets and had not maintained an accurate, up-to-date inventory of fixed assets located at its own facilities or at other locations. This suggested that the BIT and its staff should become more familiar with and follow best practices regarding fixed asset reporting and accountability.

Section 20-4 of the County Code requires the head of every department, board, or commission to furnish the director of finance a detailed list of all property under his or her control each July. Implementation of this provision has several elements. First, assets with an original acquisition cost of \$5,000 or greater must be reported to the controller on an annual basis. Second, Finance requires each department, for insurance purposes, to maintain a separate inventory of assets valued at between \$500 and \$5,000. Third, the controller recommends that a department conduct an annual physical inventory of assets. Further, generally accepted business practices dictate that an entity maintain an accurate inventory of fixed assets for accountability purposes.

We asked BIT staff to provide a schedule of its fixed assets for the period FY 1999 – FY 2001. Staff responded that BIT had no fixed assets during that period. Further, staff indicated that BIT was not required to maintain an inventory of assets valued at under \$5,000.

However, the BIT CAFRs for FY 2000 and FY 2001 reported fixed assets in excess of \$111,000. Further inquiry with Finance determined that the BIT had fixed assets ranging from \$169,000 in FY 1999 to \$111,000 in FY 2002. The assets consisted primarily of computers and a specialized computer software program physically located in OHR offices. The items were purchased with retirement plan trust funds. The BIT is accountable for the expenditure of retirement trust funds and assets. Finance staff has maintained and reported fixed asset schedules for BIT assets physically located at OHR but has not included additional equipment located at BIT offices.

We conducted a physical inspection of the BIT offices and identified numerous items that should have been recorded on an inventory of assets. These items included computers, flat screen monitors, computer printers, other computer peripherals, fax machines, televisions, a cell phone, other electronic devices, and office furniture including desks, chairs, a conference room table, and filing cabinets.

The BIT now reports creating an inventory database to record all equipment with a value of \$500 or more. The reported corrective action is duly noted and the BIT is commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

The BIT has also suggested to us that it was not responsible for tracking physical assets purchased with trust funds, but located in other offices. Basically, all we asked the BIT to do was work with others in the County to clearly define areas of responsibility for record-keeping for office equipment and computers purchased with trust funds. That seems reasonable to us.

Management controls are designed to reasonably ensure regulations are followed and reliable and timely information is obtained, maintained, reported, and used for decision-making. Controls also require accountability for the custody and use of resources. The retirement system trustees and staff have a fiduciary responsibility for safekeeping plan assets, including office equipment and computers. To fulfill that responsibility trustees and staff must understand what resources purchased with trust funds constitute fixed assets, the annual reporting requirements for those fixed assets, how fixed asset schedules are developed and maintained, the identity and location of fixed assets utilized by other entities involved in retirement system activities, the need to conduct annual physical inspections of equipment, and maintain an in-house inventory. While Finance may maintain and report certain fixed asset schedules as required, the lack of understanding of reporting requirements by trustees and staff for equipment and computers weakens management controls over these important resources.

Recommendation:

The BIT should work closely with the County:

- to ensure trustees and staff receive training on the importance of identifying and safeguarding fixed assets;
- to clearly define areas of responsibility for BIT fixed asset record-keeping;
- to identify existing BIT fixed assets including assets physically located at BIT facilities and at other entities;
- to improve communication between the BIT and Finance regarding the status of fixed assets including acquisition and disposal; and
- to improve accountability by BIT trustees and staff by conducting annual inspections of fixed assets and maintaining up-to-date inventory schedules.

Agency Response:

We do not concur with the finding on strengthening fixed assets record-keeping. The Board's physical assets over \$5,000 have consistently been reported in accordance with County policy. Physical assets under \$5,000 purchased by and located in the Board's office are included in the inventory database developed by Board staff.

The Board's response addresses physical assets it acquired for use related to the oversight of retirement plan investments. Questions related to the tracking of physical assets not located in the Board office, and acquired by and located in other County offices as described in section 2.2.1 of the OIG report, should have been directed to the Chief

Administrative Officer, who by law is plan administrator. Throughout the audit process OIG has declined to communicate with the CAO on issues of plan administration.

If OIG had done so in this case, it would have learned that the County CAFR for FY 2002 and FY 2003 includes \$111,375 in fully depreciated capital assets for the ERS. This amount represents a software program that is physically located in the Office of Human Resources No other purchases of capital assets with an original cost in excess of \$5,000 have been identified through the normal accounting processes. For FY 2003, the Department of Finance obtained year-end confirmations from fixed assets custodians in both the OHR and the Board. Those confirmations showed that no other capital assets with an original cost in excess of \$5,000 exist in either location, and that the existing capitalized asset is still in use. The confirmation packet provided to each fixed asset custodian also communicated departmental responsibilities with regard to assets with an original cost of between \$500 and \$5,000.

The County's policy requires reporting and recording of all assets over \$5,000 as fixed assets and reflecting the total on the Statement of Plan Net Assets in the Retirement Plans' CAFR. Board staff has completed the necessary forms annually as required by the County's policy and reported no assets over \$5,000.

In FY 2002 Board staff revised an inventory database to identify and record all physical assets, including assets with a value of \$500 or more located in the Board office.

2.2.2 <u>Strengthen Oversight of Equipment Purchases and Disposals</u> (Finding No. 3)

At the time we began our audit the BIT was not providing adequate oversight for the acquisition, safe-keeping, and disposal of office equipment including equipment such as computers, computer peripherals, and related equipment. When we asked for its annual inventory of fixed assets, BIT staff could not produce it.

We then conducted a physical inspection to identify fixed assets for the four-person office. During our inspection we located 16 computers (nine were laptops), ten monitors for the desktop computers (including five flat screen monitors purchased at one time), five printers (a sixth printer purchased in part with BIT funds was reportedly housed in Finance), two fax machines, five personal digital assistants, and three television sets. At that time we could not locate a computer audio card, a read/write drive, and a portable keyboard. Subsequently, the computer audio card and the read/write drive were returned to the BIT. The purchase of the portable keyboard, charged on a County travel and expense card, was disallowed by the County and reimbursement to the trust was made by deducting the cost of the purchase from the then-director of pension investments' final pay. In addition, we noted a state-of-the art projection system, installed in the conference room. The \$3,400 system had been purchased for use during board meetings. At that time we asked how the system worked and no one in the BIT office could tell us.

Trustees and staff have a fiduciary responsibility to ensure that funds are expended only for reason-able and necessary expenses related to the administration of the retirement plans.

Expenditures for computers, computer peripherals, and related electronic equipment should promote efficiency in staff operations. Once acquired, equipment should be secured to reduce the risk of theft or misuse. When equipment becomes obsolete or is deemed surplus, items should be disposed of through established policies and practices.

Although a few of the computers were older models and probably obsolete, many were still serviceable but not being used. None of the excess computers and related equipment had been designated as surplus and BIT staff had not formally disposed of any equipment. Staff stated that some items were stored at home for extended periods of time.

The BIT reports that in December 2002 it created a procedure in its administrative manual clearly outlining procurement and payment processes for the acquisition of goods and services. The reported corrective action is duly noted and the BIT is commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

Management controls are designed to reasonably ensure resources are protected from fraud, waste, abuse, and mismanagement and that accountability for the custody and use of resources is assigned and maintained. Management controls at the BIT were inadequate and allowed the acquisition of an excess amount of computers, computer peripherals, and other electronic equipment. Many of the acquisitions were unnecessary and represent a waste of financial resources. Further, some assets were not safeguarded as the BIT lost physical control over equipment that was taken off-site for extended periods of time. Finally, the BIT did not follow established policy on the disposal of surplus equipment.

Recommendation:

The BIT should continue to provide enhanced oversight of acquisition, safekeeping, and disposal of fixed assets by approving the purchase of all computers, computer peripherals, and other office electronic equipment only after reviewing in advance the necessity and justification for such purchases; reviewing the annual inventory of fixed assets and identifying obsolete or surplus items; and ensuring obsolete and surplus equipment is disposed of pursuant to established policies.

Agency Response:

We do not concur with the finding on strengthening the oversight of equipment purchases and disposals. This process has already been strengthened.

The Administrative Manual of December 2002 clearly outlines procurement and payment processes. The acquisition of equipment or services is approved by the Board through the budget process annually. If a need arises that was not approved as part of the annual budget, the procurement of the item, if under \$5,000, must be approved by either the Board Chair or the Chair of the Administrative Committee. If over \$5,000 Board approval is

required. Either action is reported to the Board as part of its quarterly budget review process. All computer related needs, including the purchase of software or equipment, are handled through the Board's IT Support Division located in the Finance Department.

As noted above, in FY 2002 Board staff revised an inventory database to identify and record all physical assets, including assets with a value of \$500 or more located in the Board office.

Computer technology has changed rapidly, especially in the area of laptops, over the past five years. OIG failed to mention one important fact about the computer equipment located in the Board office: the list goes back to **1988** and includes equipment that is more than 15 years old. Much of it is obsolete.

The then-director decided to retain the equipment rather than dispose of it. After checking with Automation Support staff, the then-director determined that equipment that was not obsolete could be used for business travel and after-hours work at home. The surplus equipment (nineteen items) was picked up by the County's vendor in May 2003 (the delay was due to the ongoing audit of Board operations and a request from Internal Audit not to send the equipment to surplus) and disposed of by the Department of Technology Services. DTS reports that the surplus equipment was not usable and was sold to a computer repair training firm for parts or recycling.

OIG's statement about the Board's conference room computer projection system is misleading. We have repeatedly advised OIG that the system is intended for video conferencing, including data transmission, to reduce travel costs for due diligence visits to current and prospective investment managers. The system has been used at numerous Board and Committee meetings by Board staff, consultants, and managers. OIG's other references to responses provided by Board staff are similarly misleading

2.3 Budget Practices and Administrative Expense Management

In this section we review the efficiency and effectiveness of the BIT budget process and resulting administrative expenses. We begin by looking at the strength of oversight in the budget process, then we examine administrative expenditures associated with the three retirement plans including personnel costs, and we end our discussion about the BIT budget and administrative expenses by focusing on questions relating to reasonableness and apportionment.

2.3.1 Oversight

Strong budget oversight for any organization is an important management control. For the BIT it is critical because of the trustees' fiduciary responsibility regarding the use of trust funds. Any meaningful budget oversight process should promote to the extent possible the independence of the fiscal policy-makers, their accountability to appropriate stakeholders, and the transparency of their decisions.

With regard to budget preparation the BIT does not use the OMB process. Therefore, the BIT budget does not receive the same scrutiny as other County office or department budgets: the BIT has no assigned OMB analyst; the BIT budget is not reviewed by the County Executive; nor does County Council directly appropriate funds in the BIT budget. County Council oversight of trust fund expenditures is included in a review of non-departmental accounts, or NDAs, where the BIT is mentioned, but no specific dollar amounts are reported. In contrast, the BIT staff puts together spreadsheets which are presented solely to the board. The board approves only the "BIT" portion of trust fund administrative expenditures (38.1 percent overall), not the County or "non-BIT" portion of trust fund administrative expenditures (61.9 percent overall) which is decided by the County administration.

More oversight of the BIT budget process by the trustees, OMB, the County Executive, and County Council may be warranted in order to keep administrative cost growth more in line with other County office and department expenditure growth. More budget oversight is also warranted to ensure proper use of trust funds in areas where there may be overlapping interests between the retirement system and the general government. For example, actuarial services are often a necessity for a retirement system in determining the actuarial soundness of the system. Those same services may also be used by the general government in costing out collective bargaining issues. While there may be economies of scale in using the same actuary for both purposes, the use of retirement trust funds would probably only be appropriate in the first instance. Trustees have a responsibility to ensure that trust funds are spent only for valid trust purposes.

2.3.2 Administrative Expenditures

Over the six-year period FY 1998 – FY 2003 administrative expenses paid from retirement trust funds have increased 59.9 percent while overall County expenditures have increased 37.4 percent. There have been no significant additional services added to the BIT program that would explain increases in administrative expenditures that are appreciably larger than the increases in costs for County operations in general. Some time-consuming, benefits-related duties have been shifted from the BIT to OHR and the County. Salaries and benefits billed to the trust funds for non-BIT County employees have increased significantly more than similar expenditures for BIT employees (91.5 percent for the former, 10.3 percent for the latter). Charges for professional services including actuarial services have increased dramatically during the period (104.9 percent) as have benefits and disability processing (78.9 percent). (**Table 14.**)

Table 14. Administrative Expenses Paid with Trust Funds								
by Object and Agency								
(FY 1998 and FY 2003)								
By Object 1998 2003 \$ Increase \$ Increase								
Salaries and Benefits	708,591	1,124,535	415,944	58.7				
Professional Services	234,159	479,838	245,679	104.9				
Benefits and Disability								
Processing	317,726	568,439	250,713	78.9				
Due Diligence								
and Education	27,799	(16,844)	(44,643)	-160.6				
Other Operating Expenses	201,030	224,813	23,783	11.8				
Total	1,489,305	2,380,781	891,476	59.9				
By Agency	By Agency							
Board of Investment Trustees	677,749	854,686	176,937	26.1				
County (Non-BIT)	811,556	1,526,095	714,539	88.0				
Total	1,489,305	2,380,781	891,476	59.9				

Source: OIG analysis of BIT data.

Knowing what was spent to administer the three retirement plans, while important, does not answer two key questions: what amount of administrative expenditures is reasonable and how should those expenditures be apportioned among the plans? One way to determine reasonableness is to look at what other similarly-situated retirement plans are spending for administration. Another possibility is to competitively bid administrative operations, thereby allowing the marketplace to answer the question.

The question of how to properly apportion administrative expenditures among the three plans is necessary to consider because of the answer's impact on the various trust funds as well as general funds. During our fieldwork we discovered several apportionment methodologies at work: mathematical formula, manager judgment, and "work done." The problem we saw with these methodologies was that they were sometimes inconsistent across programs and most often were not adequately documented. For example, lease payments for the BIT offices were apportioned 80.0 percent for ERS, 10.0 percent each for RSP and DCP. However, an analysis by actual apportionment of administrative expenses, by assets held in trust, and by membership for the three plans all showed different results. Whichever methodology or combination of methodologies is most appropriate to use should be well-documented, applied consistently, and subject to periodic review. (**Table 15.**)

Table 15. Apportionment of Administrative Expenses (FY 2003)							
DI	Actual Annortionment Assets Held In Trust Members/Particinan						
Plan	(\$) ½	(%)	(\$) ² /	(%)	(#)	(%)	
ERS	2,007	84.3	1,726.5	87.8	10,620	56.9	
RSP	210	8.8	40.2	2.0	3,206	17.2	
DCP	163	6.9	199.6	10.2	4,841	25.9	
Total	2,380	100.0	1,966.3	100.0	18,667	100.0	

Source: OIG analysis of BIT data.

The following sections 2.3.3 through 2.3.9 contain our findings and recommendations as well as the BIT responses regarding budget practices and administrative expenditure management.

2.3.3 Strengthen Oversight of Budget Process

(Finding No. 4)

We did not find evidence that the BIT provides adequate oversight of the total trust fund operating budget. The 2000, 2001, and 2002 CAFRs for the Montgomery County Employee Retirement Plans addressed to County Council and the County Executive state in part, "[T]he Board of Investment Trustees approves and actively monitors the annual budget for each plan." The 2003 CAFR states in part, "[T]he board, in conjunction with the chief administrative officer, approves and actively monitors the annual budgets for each plan." (Emphasis added.) Those affirmative statements have appeared each year that the BIT has published its own CAFR. During our fieldwork we attempted to verify the correctness of those statements and found that we could not. The BIT tells us that assuming those duties would exceed County law.

When we interviewed current and former trustees and senior staff, under conditions of confidentiality where the persons being interviewed could speak freely, we asked a series of several questions relating to budget oversight and the budget process. The following are some answers we received:

- Not aware of how budget is prepared but assumes numbers come from Finance.
 Budget is reviewed in detail by the Board; members have expressed concern with
 expenses... Has not heard major disagreements or dissent. Impressed with
 thoroughness and concern; everything is vetted.
- Non-BIT numbers are prepared by other departments. Those amounts are accepted by BIT. Whether or not the board "approves" the non-BIT portion of the budget is a "good question."
- Prepared by BIT staff; presented to Board for approval. Aware that other department's budgets included in BIT budget.

½ In thousands. ½ In millions

- [A]mount of trust money used for non-BIT portion is decided by Montgomery County administration. OMB director "negotiates" with Finance and OHR. According to [interviewee] all BIT members are aware of this process.
- Department costs determined by each department but reviewed by OMB; BIT has no role. Department costs are presented to the Board for information purposes only; trustees could raise questions about specific costs but do not actually vote to approve the costs.
- Finance prepared; Board little discussion, rubber stamp
- BIT staff works with OHR, Finance, and OMB concerning the development of the non-BIT portion of the budget. The whole budget comes first to the administrative committee and then before the full board. It is reviewed line-by-line. BIT expenses receive close scrutiny. The board tries very hard to keep expenses under control.
- Board reviews the budget annually, vetted first in committee. Always an open discussion. ... [Names of ex-officios] drive the discussion.
- Budget reviewed but not quarterly, not regularly

According to information on "actual budget" figures supplied to us by BIT staff, between FY 1998 and FY 2003 administrative expenditures for the three employee retirement plans totaled nearly \$11.7 million. Overall these costs increased from \$1,489,305 in FY 1998 to \$2,380,781 in FY 2003 (59.9 percent).

In reality the BIT budget is actually two budgets. One part commonly referred to as "BIT" uses trust funds to pay trustee expenses such as BIT staff salaries, travel for trustees and staff, and rent for the BIT office. Between FY 1998 and FY 2002 actual expenditures for the "BIT" portion of the budget increased from \$677,749 to \$926,807 (36.8 percent) before declining to \$854,686 in FY 2003. These "BIT" expenditures accounted for 38.1 percent of trust fund expenditures for administrative purposes over the six-year period.

The other part of the BIT budget is commonly referred to as "non-BIT." This part uses trust funds to pay costs associated with County government's administration of the three plans including the salaries of approximately 11.6 FTEs in Finance, OHR, and County Attorney. During the six-year period FY 1998 – FY 2003, "non-BIT" expenditures, which accounted for 61.9 percent of trust fund expenditures for administrative purposes, increased from \$811,556 to \$1,526,095 (88.0 percent). By comparison, during that same six-year period, the cost of living in the Washington Metropolitan area increased by approximately 15.2 percent, while overall County spending increased by 37.4 percent.

The "BIT" part of the total trust fund budget receives some initial scrutiny by trustees early in the budget approval process; however, the "non-BIT" or what is sometimes referred to as the County portion of the trust fund budget receives far less scrutiny at that time. Also, for both "BIT" and "non-BIT" activities, trustees do not review any additional expenditure of trust funds over and above the amounts initially identified, but simply ratify any expenditure adjustments near the end of the fiscal year. County Council does provide limited review of some BIT activities via NDA oversight during the County's budget approval process.

The BIT, in this finding as well as several others, takes OIG to task for not communicating with the CAO. In fact, we have communicated with the CAO when in our judgment it was necessary to further audit objectives. For example, we spoke with the CAO several times regarding our investigation of the former director of pension investments. We communicated directly with the CAO on issues regarding follow-up from prior audits. In addition, we spoke with the senior managers who report directly to the CAO about a range of issues involving the retirement plans and administrative management practices. These managers included the directors of finance, OMB, and OHR. The recommendation for this finding is for the BIT to work closely with the County to strengthen oversight. Notwithstanding what the law says, that doesn't strike us as being unreasonable or unattainable. The BIT publicly represents that it approves and actively monitors the annual budgets for each plan. It should do so.

Sound business practices require effective budget planning and oversight in order to adequately ensure appropriate accountability for public funds including employee retirement trust funds. Every year there have been significant cost overruns in "BIT" or "non-BIT" budgets that might have been avoided with better planning and oversight. Closer scrutiny of both the "BIT" and "non-BIT" (or County) portions of the total trust fund budget could very well result in cost savings which in turn would result in more money being made available to the trustees for investment on behalf of the members and beneficiaries of the three employee retirement plans.

Recommendation:

The BIT should work closely with the County administration to strengthen oversight of the total trust fund operating budget with particular emphasis on administrative expenditures using trust funds from the three employee retirement plans. Specifically, the trustees should review a detailed budget plan for both "BIT" and "non-BIT" expenditures including supplemental appropriations. The BIT review should focus on the amount of trust funds to be used to pay for County employee salaries and benefits; the amount of trust funds to be used to pay for professional services; and the amount of trust funds to be used to pay for other operating expenses. The BIT should carefully review "BIT" and "non-BIT" expenditure proposals and note its review with a formal recorded vote of the trustees.

We further recommend the trustees request County Council strengthen its oversight role. Nothing contained in this recommendation is meant to diminish the CAO's ability to administer the three employee retirement plans as required by law.

Agency Response:

We do not concur with the finding that the Board should strengthen oversight of the budget, and plan administrative expenditures in particular. The Board's oversight of the "BIT" budget is effective. By law the "non-BIT" expenditures are determined by the CAO, who is the plan administrator and a fiduciary. OIG's analysis of this issue is flawed.

Section 33-47 (e) and Section 33-60(d)(12) of the Montgomery County Code require that at the direction of the CAO the Board **must** pay from plan assets the operating expenses for all non-Board activities related to plan administration. That is the law. As Board staff explained to OIG, allocation of fiduciary duties among and between fiduciaries is common practice in employee benefit plans. Once again, OIG's use of excerpts from "confidential" interviews with trustees, where the question, respondent, and context are unclear, adds no value.

In this area, as in many others, OIG recommends that the Board assume duties that far exceed what County law stipulates. Although by law the CAO is plan administrator and a fiduciary, OIG has declined to communicate with the CAO on issues of plan administration. If OIG had done so in this case, it would have learned that the increase in non-BIT expenses under the CAO's aegis is the result of specific components – for example, costs to administer the new Deferred Retirement Option Program mandated by collective bargaining agreements with the police and fire unions, purchase a Y2K-compliant pension calculation processing system, and implement a disability review and arbitration process mandated by County law. OIG would also have learned that OMB uses a MARC (Maximum Agency Request Ceiling) process for non-BIT expenses and that any requests above the MARC must go on the so-called "competition list" for funding. In addition, OIG would have learned that the CAO has acted to further strengthen his oversight of non-BIT expenses.

In April 2000 the Board retained a national consulting firm to conduct an operational audit. The firm is a registered investment adviser and regularly consults with pension plans on structure, governance, and oversight issues. The firm did not recommend expanding the Board's oversight of administrative expenses incurred by other County offices. The firm did recommend transferring administrative duties being performed by Board staff, and not related to the investment process, to the Office of Human Resources (OHR). The duties were transferred in FY 2003.

The Board's annual budget evolves through a lengthy construction, review, and approval process that encompasses presentations to the Administrative Committee in November and February for their comments/changes and to the full Board in December (preliminary budget) and March (final budget) for their approval. The budget process is documented in the Board minutes and committee reports. The Board reviews each budget line item to determine the appropriateness of staff's projections. Starting with the first quarter of FY 2003 the Board has reviewed actual versus budgeted expenses quarterly to ensure compliance. As stated in our response to finding #3, all expenses not budgeted must be approved by the Board Chair or Administrative Committee Chair and are reported to the Board as part of the quarterly review process. The budgets for all three plans are included in the County Executive's recommended budget each March.

OIG makes reference to the clarification in the FY 2003 Retirement Plans' CAFR to the joint responsibility of the Board and the CAO for budget oversight of the plans. This change accurately reflects what is mandated by law and has been operationally in place since the Board was created.

The Board allocates administrative expenses associated with the investment programs it oversees that are not plan-specific on the following basis: 80% ERS, 10% RSP, and 10% DCP. This allocation is based on the work effort required by Board staff in overseeing the programs. This allocation method is reviewed annually as part of the Board budget approval process, and adjustments are made as necessary.

Table 14 shows that the administrative costs associated with the Board's operations for all three plans increased by 26.1% from FY 1998 to FY 2003, well below the 37.4% for overall County operations. This is so even though the Board's administrative costs fluctuate annually based on one-time events such as: consultant studies undertaken to review operations of the Board, \$100,000; outside auditors performing non-routine audit work, \$75,000; and Board office relocation costs, \$50,000. Additional administrative charges that were incurred after FY 1998 and will continue to be paid annually include: rent expense, \$100,000; auditors' fees, \$30,000; and increased benefit disbursement costs, which increase quarterly based on the number of retirees and beneficiaries receiving benefits. The fees related to benefit payments have increased by \$85,000 from FY 1998 to FY 2002. Due diligence costs increased as the Board moved into new asset classes such as TIPS and private equity and a new custodian bank arrangement.

Total administrative costs result from specific component parts of this kind. OIG takes a broad-brush approach but should be interested in analyzing these component parts. As noted above, one of the Board's significant achievements is that according to a national pension consulting firm, total expenses for the ERS in FY 2002 were nearly 10% below those of like public pension funds. The Board achieved this result by aggressively negotiating fees with investment managers, consultants, and other vendors.

OIG's suggestion that the Council strengthen its role in the budget process for the three plans is for the Council to consider. In crafting the law in 1987, the Council established that the Board and the CAO are fiduciaries with regard to their specific duties, including payment of their respective expenses. The Council's clear intent was to delegate this responsibility; it did not include itself as a named fiduciary with budget oversight.

2.3.4 Reduce Administrative Expenditures

(Finding No. 5)

There has not been sufficient restraint on rising administrative costs. As was mentioned previously, administrative expenditures charged to the trust funds increased by 59.9 percent between FY 1998 and FY 2003 with the "BIT" portion of the budget increasing by 26.1 percent and the "non-BIT" County portion increasing by 88.0 percent. During the six-year period total trust fund administrative expenditures were over budget five times. Overall spending for County government and independent County agencies increased 37.4 percent during the period. At the same time the consumer price index for the area increased at about two percent annually.

Applying the County's expenditure growth rate of 37.4 percent to total administrative expenditures of \$1,489,305 for FY 1998, administrative expenditures for FY 2003 would have grown to \$2,046,305 instead of the actual spending of \$2,380,891, a difference of

\$334,586. (Had administrative expenditure growth been limited to increases in the consumer price index the difference would have been \$664,212.) We have identified specific savings in findings nos. 7, 8, and 9 which could be components of the \$334,586. An additional area the BIT might want to explore with the County that could yield additional savings is professional services, specifically actuarial fees. Those fees increased from \$160,528 in FY 1998 to \$529,044 in FY 2001 (229.6 percent) before falling to \$311,835 in FY 2003 (an increase over the six-year period of 94.3 percent).

The BIT appears to ridicule OIG for suggesting administrative spending restraint and tells us that the County does not budget in this "unsubstantiated way." However, County Council and the County Executive recently asked many departments and offices to reduce FY 2004 spending by three percent. Our proposal calls for a reduction in the trust fund FY 2004 spending base of 6.5 percent over and above those amounts identified in findings nos. 7, 8, and 9, an amount which doesn't seem to us to be all that unreasonable given the current fiscal climate.

The bifurcated budget-making process involving "BIT" and "non-BIT" (County) expenditures increases the need for additional "checks and balances" and for greater oversight from the trustees. Trustees have a fiduciary responsibility to ensure trust funds are spent in a reasonable and prudent manner and only for necessary purposes. If administrative costs paid from trust funds are brought more into line with other County expenditures, the results could translate into more trust funds available for investment, savings for County taxpayers, or a combination of both.

Recommendation:

The BIT should work more closely with the County administration to keep future trust fund administrative expenditures to a rate of increase at or below that for other County spending. In addition, for FY 2005 the BIT should work with the County administration to reduce total administrative spending by \$334,586 which may include savings identified in findings nos. 7, 8, and 9.

Agency Response:

We do not concur with the finding that the Board lacks sufficient oversight of administrative costs. Our reasons, including the requirements of County law and the role of the CAO as plan administrator and fiduciary, are stated clearly in our response to finding #4. The recommendation to cut administrative spending "by \$334,586" is not valid.

What is the basis for this figure? What analysis has OIG done of the specific components of the administrative expenses? Which ones does OIG think should be reduced and by how much — such as the DROP program, the Y2K-compliant pension calculation processing system, or the disability review and arbitration process? Why does OIG want to arbitrarily "reduce" just \$334,586 in administrative expenses? Why not stipulate \$400,000 or \$500,000? Auditors are supposed to be specific and concrete. The County does not budget in this unsubstantiated way.

We should note again that according to OIG's own figures, between FY 1998 and FY 2003 the BIT budget rose by 26.1% while the overall County budget rose by 37.4%. OIG's focus is on the non-BIT budget, which by law is determined by the CAO.

We should also note that in some cases the County Code, or state or federal law, limit the Board's flexibility on administrative costs. For example, for implementation of GASB 34 and 37, the Board was not permitted to incur the expenses in a future year. Implementation was mandated, and the related costs needed to be incurred then.

2.3.5 Establish Methodology to Support Non-BIT Employee Costs (Finding No. 6)

There is a lack of an appropriate methodology and adequate documentation to support the allocation of trust funds for payment of salary and benefits to certain County employees. Under the Internal Revenue Code and County law trust funds should be used for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of the plans, and no part of the trust funds should ever inure to the benefit of the County. (Emphasis added.) Ensuring that trust funds are used for the exclusive purpose of defraying reasonable expenses requires, at a minimum, a methodologically-sound cost allocation plan supported by adequate documentation.

According to information we were provided, a total of 30 County employees outside of BIT are being compensated in whole or in part using employee retirement trust funds. For FY 2003 this amounted to 11.6 work years apportioned as follows (number of employees partially compensated from trust funds in parentheses): Finance 1 (4), OHR 9.6 (25), county attorney 1 (1).

During the six-year period FY 1998 – FY 2003 BIT reported to us that over \$5.1 million was spent for salaries and benefits. Of that amount more than \$3.3 million (65.8 percent) was spent for County non-BIT staff. We have no reason to doubt that substantial administrative work relating to the three employee retirement funds is being done by the 30 County employees outside BIT offices. However, methodologies used by County departments to calculate that work did not provide adequate documentation which would allow us to verify either the dollars spent or the work performed with any reasonable assurance of accuracy.

For example, Finance charges 100 percent of an accountant's salary and benefits to trust funds even though the employee acknowledged spending less than 100 percent of his time on trust fund activities. Three additional employees in the department also work on trust fund issues from time to time, but charge no time to the trust funds. The department believes that, overall, its methodology results in a fair charge to the BIT. In OHR, 50 percent of the benefits team's time (five work years) is allocated to the ERS while 15 percent of the OHR director's time is allocated to the ERS and five percent to the DCP, but nothing to the RSP. In the county attorney's office 100 percent of an assistant county attorney's position was allocated to trust funds, 70 percent directly and 30 percent through OHR. We saw no documentation or other evidence to support the cost allocation methodologies used.

The BIT suggests that sufficient documentation to support cost allocations exists. For example, we were told that OHR, which incurs most of the non-BIT costs, has a detailed "workforce crosswalk" that "...clearly shows the cost allocation for all affected positions [and that] [t]his allocation is accurately reflected in employees' timesheets." The problem we saw with the "workforce crosswalk" spreadsheet was that it lacked supporting documentation. Therefore, the fact that employees' timesheets might accurately reflect the "workforce crosswalk" is essentially meaningless. For example, the "workforce crosswalk" we saw allocated 20 percent of the OHR director's salary to trust funds. Why 20 percent was not clear. We question whether, on its face without any supporting documentation, that is a fair allocation of trust funds, especially given that the OHR director is an ex-officio trustee and trustees are supposed to serve without compensation from any source for service rendered to the board, except that an active employee trustee may receive administrative leave to serve on the board.

Sound business practice requires the application of an appropriate cost allocation formula before using trust funds to offset general fund costs. The lack of an appropriate cost allocation formula and supporting documentation makes it very difficult to ascertain whether trust funds are being used only to support activities related to the County's three employee retirement programs.

Recommendation:

The BIT should work more closely with the County administration to document the terms and conditions under which trust funds can be used to pay salary and benefits for County employees. At a minimum the documentation should specify the cost allocation methodologies to be used and provide for periodic review of the accuracy of the methodologies.

Agency Response:

We do not concur with the finding that the Board should establish a methodology to support non-Board employee costs charged to the plans. As a matter of law, it is the CAO, as plan administrator and fiduciary, who must ensure that charges to trust fund assets support activities related to the retirement plans and are used for the exclusive purpose of providing benefits to participants and beneficiaries. In fact, the methodology for these costs – which cover retirement administration, accounting, and legal services – is clear.

We have made this same point with regard to findings #4 and #5. The report itself says in the introduction section, "The BIT is primarily engaged in the investment of all trust funds, while the County is engaged in plan administration activities."

The Board urged OIG to communicate directly with the CAO on the issue of cost allocation methodology. On this as on all other matters that fall under the CAO, OIG declined to do so. OIG notes that the Finance Department believes that "overall, its methodology results in a fair charge...." As a matter of fairness and completeness, OIG should have spelled out why Finance feels that way.

Finance has determined that the total time allocated by its staff members who provide accounting services to the retirement plans approximates 100% of a workyear. Instead of establishing individual chargebacks on the timesheet of each position involved, Finance coded the primary staff position, a Senior Financial Specialist, in the personnel system to charge 100% of the work year to the affected funds.

As for the Office of Human Resources, which incurs most of the non-BIT costs, OIG has seen OHR's detailed "workforce crosswalk." This annual four-page spreadsheet clearly shows the cost allocation for all affected positions. This allocation is accurately reflected in employees' timesheets.

To be more specific, OHR deals with the administration of 18 different sub-retirement plans as well as the Deferred Compensation Plan with a customer base of more than 10,000 active employees, retirees, and beneficiaries. In FY 2003 OHR assigned 8.4 workyears to these tasks – 6.1 for the ERS, 1.3 for the RSP, and 1.0 for the DCP. Their core maintenance functions for plan administration are as follows:

Employees' Retirement System	Retirement Savings Plan	457 Plan
Process retirement projections	Enroll participants	Enroll participants
Process retirements	Process distributions	Process distributions (hardship requests)
Process purchase/transfer requests	Process severance plan payments	Process "catch-up" Requests
Process QDROs	Process QDROs	Process QDROs
Process disabilities, including the arbitration process	Process disabilities, including the arbitration process	Process contribution changes
Process integration requests Process DROP	Reconcile contribution wires to provider	Reconcile contribution wires to provider Monitor contribution limits
entries/exits Process contribution/purchase refunds Process 5 year letters Process vestings		
General customer service (phone/walk-ins/e-mail, letters)	General customer service (phone/walk-ins/e-mail, letters)	General customer service (phone/walk-ins/e-mail, letters)

Conduct orientation Conduct one-on-one counseling sessions Conduct monthly seminars	Conduct orientation	Conduct orientation Coordinate service provider sessions with participants
Prepare, update and distribute communication material (Summary Plan Descriptions, Transfer Season material, HR Topics etc.)	Prepare, update and distribute communication material (Summary Plan Descriptions , HR Topics etc.)	Prepare, update and distribute communication material (HR Topics, etc.)
Prepare required amendments to the County Code	Prepare required amendments to the County Code	Prepare required amendments to the County Code; maintain Plan Document
Maintain HR Resource Library and e-subscription	Maintain HR Resource Library and e-subscription	Maintain HR Resource Library and e-subscription

2.3.6 Reduce BIT Staff

(Finding No. 7)

At the time we began our audit we observed that the BIT program specialist and principal administrative aide positions were not necessary for the efficient operation of BIT investment activities. The program specialist position is classified at grade 18 and the principal administrative position, currently vacant, is classified at grade 13. The annual costs for these positions, at mid-range including benefits, is approximately \$99,000. Existing or proposed staff, including the staff accountant position mentioned in finding no. 14, should be able to absorb any investment management support duties and functions previously performed by the program specialist and the principal administrative aide. We understand that the trustees are currently in the process of restructuring staff.

The BIT reports that staff reorganization work with OHR began in July 2002 (just after we began our audit fieldwork) and is a work in progress with both the program specialist and principal administrative aide positions vacant. The reported corrective action is duly noted and the BIT is commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

Recommendation:

The BIT should move forward and complete its staff reorganization including plans to abolish the positions of program specialist and principal administrative aide.

Agency Response:

We concur in part with the finding to reduce Board staff. The Board is already well along with its reorganization. OIG's claim of "savings" of \$99,000 per year is not valid for two reasons.

First, in March 2001 the Board itself decided to shift plan administration-related duties to OHR and to reorganize the staff. (Board minutes and Committee reports confirm this action.) This decision was consistent with our consultant's audit report, which the Board commissioned in April 2000. Work with OHR on the reorganization began in July 2002. The fourth staff position (principal administrative aide) has been vacant since December 2002. Second, OIG cannot arbitrarily assume that funds for accounting services in the Finance Department can simply be taken to fund the Board's new third position (accountant). (See also our response to finding #14.) For these reasons OIG has no basis to claim "savings" of \$99,000 per year.

2.3.7 Reduce Real Property Lease Payments

(Finding No. 8)

The BIT is in the second year of a seven year lease and is paying for more office space than it reasonably needs to conduct its operations. Before FY 2002, BIT operations were housed in the County's Executive Office Building. However, the County needed the space for its Finance operations and the BIT was forced to leave. The County entered into a lease on behalf of the BIT for 5,156 square feet of class A office space in the Rockville core at a cost of \$1,280,397 for the lease term (\$30.50 per square foot with an annual escalator of five percent). Initially the space was to be shared with the County's internal audit section, but general fund budget constraints prevented that from occurring. Subsequently the BIT sublet 1,500 square feet of the space to the County's workforce investment services division. This would have left trust funds paying \$907,801 over the term of the lease for the remaining 3,656 square feet.

The BIT later reported to us that it was actually occupying 2,815 square feet and that the workforce investment services division had the remaining 2,341 square feet not 1,500 as originally indicated. Still later, the BIT told us it was occupying 3,036 square feet with the remaining 2,120 square feet being subleased.

County space allocation guidelines found in Administrative Procedure 5-12 approved on September 1, 1998 determine the size of office space by grade levels and job functions of employees. These guidelines show that BIT operations require at most no more than 1,587 sq. ft. of office space as follows:

•	executive director (department director)	280 sq. ft.
•	senior investment officer (senior or supervisory professional)	140 sq. ft.
•	accountant (professional)	120 sq. ft.
•	conference room (twenty person)	500 sq. ft.
•	additional space (one professional office)	120 sq. ft.

factor for interior hallways, common areas, closets, etc.
 factor for restrooms, elevators, etc.
 Total
 200 sq. ft.
 227 sq. ft.
 1,587 sq. ft.

Based on the County's space allocation guidelines and the terms of the lease, the rent for 1,587 square feet (30.8 percent of the total leased space) for BIT operations for seven years at the market rate should have been \$394,362. Assuming that the BIT pays for 3,036 square feet, (and is reimbursed by its co-tenant for space it was occupying for approximately 18 months, but for which it was not paying) total cost to trust funds for the seven years of the lease will be \$754,153 or a difference of \$359,791 for the excess 1,449 square feet. (**Table 16.**)

Table 16. A by Squa	Summary of the are Footage and	BIT Lease Attributed	e I Cost
Item Description	Square Feet	%	Attributed Cost
BIT leased this amount of space	5,156	100.0	\$1,280,397
County guidelines say this is what BIT should have leased	1,587	30.8	\$ 394,362
This is the excess space BIT originally leased	3,569	69.2	\$ 886,035
This is the space BIT is now leasing to a co-tenant	2,120	41.1	\$ 526,243
This is the excess space BIT is currently leasing	1,449	28.1	\$ 359,792

Source: OIG analysis of BIT data.

The BIT told us, without offering any proof, that Facilities indicated "most County four-person offices conducting <u>similar business</u> in the Rockville corridor have leased space ranging from 1,900 to 2,400 square feet." (Emphasis ours). If that is true, then most of those four-person offices have been permitted to significantly exceed County office space guidelines. In addition to the upper-end of the range (2,400 square feet), the BIT would like to <u>add</u> 600 square feet to account for its conference room. (We note that Facilities has told us that our four-person office located in the Rockville corridor has 1,952 square feet <u>including</u> a conference room.)

Recommendation:

The BIT should reduce its lease payments going forward by \$292,402 over the remaining period of the lease by renegotiating the lease, by entering into additional subleasing arrangements, or by recouping excess lease costs from the County. That amount is based on the BIT in the future allocating to itself 30.8 percent of the leased space in conformity with County space allocation guidelines.

The BIT should make the trust whole by recouping: \$28,819 from the co-tenant for 18 months rental of 620 square feet the co-tenant was actually subleasing from the BIT but not paying for and \$67,389 from the County for negotiating a lease for the BIT that provided 91.3 percent more space than County guidelines permitted.

Agency Response:

We concur in part that the Board should reduce its real property lease payments. The County's Facilities Division, which procured the Board's office space in 2000, negotiated the best lease it could in a tight market.

Since then the Board has worked consistently with Facilities to reduce costs. Board staff has already re-negotiated the allocation of the rent based on the square footage used by the Board and its co-tenant, and the co-tenant has already reimbursed the trust.

In 2000 the Board office had to move from the Executive Office Building when the County's Finance Department needed additional space. When Facilities started to procure the current office space, the commercial rental real estate market in the Rockville corridor was very tight. Lease provisions were stipulating required minimum square footage. The Board's requirements for rental space were very specific: close proximity to the Offices of Human Resources, County Attorney, and Management and Budget as well as the Finance Department; adequate parking for Board members, vendors, and investment managers; reasonable fee per square foot; a conference room that could seat 15-20 people; and provision for potential future staff expansion.

Facilities determined that the best available location meeting these criteria would be at 11 North Washington Street, a building then under construction. The landlord required Facilities to take the minimum space allocation of 5,000 square feet. Facilities negotiated the per-square foot charges, build-outs, and office space requirements. The Board minutes of December 2000 reflect the Board's discussion and approval of the budgeted amount. The Finance Director authorized the Internal Audit Section to move its office from the Executive Office Building to occupy approximately 2,000 square feet within the space chosen by Facilities for the Board office. When Internal Audit decided not to move, a new co-tenant had to be found. Workforce Development began leasing the space in March 2002.

The Board's current occupied space is 3,036 square feet, including 616 square feet for the conference room (493 square feet plus 25% for interior partitions and building). Facilities says that for most County four-person offices conducting similar business in the Rockville corridor, it has leased space ranging from 1,900 to 2,400 square feet. (The office currently has three staff positions. The remaining space is for interns, temporary help, auditors, investment advisors and counselors, and other visitors as needed.) If the square footage of the conference room is subtracted from the actual space used by Board staff, the office falls within Facilities' range.

The Board obviously would like Facilities to provide more cost-effective space and therefore continues to work aggressively with Facilities to reduce costs. OIG itself faces a somewhat similar challenge. The report states that OIG's own office, which it has occupied since 1998, has 1,952 square feet, 23% more than the 1,587 permitted by the "County guidelines" it cites. To be fair, OIG's space, like the Board's, represents the best procurement Facilities could make at the time.

2.3.8 Reduce Payments for Data Service

(Finding No. 9)

During our fieldwork we observed that the BIT was paying for unnecessary business resources by currently paying \$33,240 annually for two subscriptions to an interactive, financial information network. One subscription to the network, which provides data, news, analyses, multimedia reports and e-mail 24 hours a day, is a reasonable use of trust funds. The service is used by professional investors around the world and we do not question its value. However, given the small office environment at the BIT and the job responsibilities of the executive director and senior investment officer, the second subscription is unnecessary.

The BIT reports that in December 2002 it decided to eliminate one of the two data terminals effective in March 2004 (fifteen months and \$20,775 later) in order to avoid early cancellation fees. The reported corrective action is duly noted and the BIT is commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

Recommendation:

The BIT should move forward expeditiously with the cancellation of one of the data service subscriptions thereby saving the trust funds \$16,620 annually.

Agency Response:

We concur in part. This is another finding that mirrors action the Board has already taken. The Board itself decided in December 2002 to reduce costs by eliminating one of the two data terminals. The Board felt that even though both terminals were extensively used to analyze investments, one terminal in an accessible location would suffice. OIG should not credit itself with "savings."

To avoid early cancellation fees of \$14,000, the Board elected to wait until the current contract expires in March 2004. The Board notified the vendor to cancel the second data terminal on January 5, 2004, as required by the contract (60 days notice prior to cancellation).

2.3.9 Study Further Outsourcing of Plan Administration Activities (Finding No. 10)

The BIT has not worked with the County to carefully and fully evaluate the cost effectiveness of plan administration services, commonly referred to as third-party administrator or TPA services. These plan administration services are provided by County government and included in the "non-BIT" portion of the trust fund administrative expenditures budget. Those services have increased at a rate significantly faster than both the cost of living and

the rate of County expenditures generally even though there have not been any major changes in the services provided.

For the most part plan administration activities include those activities undertaken by personnel in OHR: benefits and records management, occupational medical services, member/participant education, legal services, and general management. These activities are budgeted using trust funds identified as "non-BIT" expenditures and account for approximately 60 percent of all trustee-paid administrative expenses.

TPA services are readily available on a competitive basis from private sector providers. The BIT bears a fiduciary responsibility to members/participants – the highest duty recognized under law. Fiduciaries are required to defer to the best interests of their beneficiaries even when those duties conflict with other corporate interests. The BIT has a duty to work with the County to ensure that trust resources are being used in the most cost effective manner.

The BIT has provided a summary of current outsourcing. We do not believe we are asking the board to violate the law when we ask it to collaborate with the County in seeking ways to increase the efficiency and effectiveness of trust fund programs.

Recommendation:

The BIT should work collaboratively with the County to study the potential for any savings that might be gained by further outsourcing plan administration activities and services to a private sector TPA. If competitive bidding is deemed to be appropriate, County employees should be assisted in submitting such a bid.

Agency Response:

We do not concur that the Board should ask the County to study the outsourcing of plan administration activities. By law this function is the responsibility of the CAO. Throughout the audit process OIG has declined to communicate with the CAO, the plan administrator, on issues of plan administration. This has deprived OIG of information it should know, such as the extensive outsourcing that already exists.

Activities that are currently outsourced by the Office of Human Resources include ERS retiree benefit payments, enrollment in the RSP and DCP, and distributions from the RSP and DCP. In addition, the process to select a third party administrator for the DCP starting in 2004 is well under way. The Board itself contracts extensively for investment management, consultant assistance, and counseling for RSP members.

2.4 Governance and Management Controls

In this section we evaluate the efficiency and effectiveness of the BIT governance and management control structure. There is nothing more important to an organization's success than how well it is governed. Indeed corporate governance issues dominate business news

today. Good, effective governance is the ultimate management control. The tone at the top very often sets the tone for the entire organization. To be most effective, organizational governance should be independent of undue pressures and narrow special interests, fully accountable to legitimate stakeholders, and reasonably transparent in the way in which it makes decisions and reports on its operations. Our review of the available literature suggests that there is no one best governance model for a retirement system, but rather there are several models in use today.

2.4.1 Governance Models

In one model the organization itself manages both the investments and the administration of the plan. In this model the investments are managed along with other cash and debt management responsibilities by the finance department or its equivalent, while the personnel department manages the educational and administrative components of the retirement plan. At the opposite end of the spectrum is a completely autonomous agency (often with a completely independent elected or appointed board of trustees, but occasionally with a single trustee) set up to manage both the investments and plan administration. A third model is a hybrid situation where a trustee or trustees manage the investment portfolio either directly or through contract managers while the organization handles plan administration. The BIT is similar to the hybrid model.

Within the models using trustees to manage the trust funds there are also variations of how the trustees are chosen: elected directly by various constituencies, appointed by the appointing authority from among the constituencies, appointed at-large, or a combination. Some appointing authorities will choose a professional from a bank or trust company. Whatever manner or model, trustees and their agents are considered fiduciaries who must act solely in the interest of the members or participants of the retirement system and their beneficiaries

2.4.2 Independence

The members of the Board of Investment Trustees are fiduciaries of the trust funds of the three employee retirement plans. As such the BIT is required to act as a body to safeguard the assets of the trusts. The independence necessary for the trustees to carry out their duties doesn't require complete organizational independence, but it does require the trustees be free of excessive interference and act in the best interest of the trust at all times to maximize assets while minimizing liabilities.

To further the procedural independence of the BIT while at the same time recognizing its role within the County's organizational structure, we are suggesting several modest but significant changes. First, we propose the number of independent trustees (those who are not member/participant trustees or ex-officio trustees) be increased from two to three. Then we encourage the trustees to find a way to exercise more independent control over professional services consultants and staff including a full-time accountant. We are convinced that those actions will enhance the procedural independence of the BIT as it fulfills its statutorily-mandated fiduciary responsibilities.

2.4.3 Accountability

According to the comptroller general of the U.S., "The concept of accountability for public resources is key to our nation's governing process and a critical element for a healthy democracy. Legislators, government officials, and the public want to know whether government services are being provided efficiently, effectively, economically, and in compliance with laws and regulations." The County requires most audits including those for the BIT to be performed in accordance with generally accepted government auditing standards. Those standards contribute to making governments more accountable for the use of public resources. Audits performed in accord with the standards should provide reliable information about an entity's financial position and its management controls including compliance with laws and regulations and provisions of contracts and other agreements as they relate to financial transactions, systems, and processes.

In order to enhance the legal, fiscal, and ethical accountability of retirement system programs and activities, we recommend the BIT pay increased attention to the exercise of reasonable care and oversight in the preparation and audit of BIT financial statements including the application of government auditing standards. Also, because of the number, complexity, and dollar amounts of contracts the BIT has with investment managers, service providers, and consultants, we encourage the BIT to assign staff responsibility and oversight for contract administration.

2.4.4 Transparency

The concept of transparency with respect to public funds including trust funds is one in which little or nothing regarding processes or procedures is hidden from public view or the view of various stakeholders. We recommend the BIT require the prompt transmittal by the County of all trust funds.

The following sections 2.4.5 through 2.4.11 contain our findings and recommendations as well as the BIT responses regarding governance and management controls.

2.4.5 Seek Increase in Number of Independent Trustees (Finding No. 11)

The BIT has relied too heavily on ex-officio board members regarding administrative management practices. We found that as BIT ex-officio trustees took the lead in various administrative areas, the other trustees tended to be less engaged and to defer to the ex-officio members in many important administrative areas. As a result, the other trustee groups, those representing retirement system members and independent trustees, may not have fully exercised their overall fiduciary responsibilities in a manner that promotes the best interests of all participants and beneficiaries.

When we interviewed current and former trustees, under conditions of confidentiality where the persons being interviewed could speak freely, we asked questions concerning budget issues; problems/obstacles encountered as board members; involvement in and understand-

ing of audit issues; procurement issues including professional services; and an open-ended question about how to make the board better. The following are comments we heard from the current and former board members:

- County reps [ex-officios] are the prime people who sit on the board.
- The ex-officio members are very strong, did not realize the power [they] held until the [consultant] study was completed. There may be a need to balance power perhaps with a more independent board. Accountability resides with the board.
- Sever from County completely.
- Board needs to be more involved in all aspects of program ... Board needs to audit County portion of work; rely too much on good faith of County.
- Don't know who [auditors] are or how they are selected.
- Thinks all consultant work should be done for the board, including actuary review.

By County law four of the nine trustees are ex-officio trustees and along with the other five are appointed by the County Executive and confirmed by County Council. In a survey of state and local government employee retirement systems published in March 2002, 171 jurisdictions reported on the make-up of their boards. Three-fourths of the jurisdictions (128) reported having two or fewer ex-officio members. Of the 59 local government systems (cities, towns, and counties) reporting, only three (including Montgomery County) reported having as many as four ex-officio trustees. Fifteen county retirement systems were included in the survey; only Montgomery County reported as many as four ex-officio board members.

There is nothing inherently wrong with a board having ex-officio board members. In fact ex-officio members often provide a strong institutional memory in key administrative areas. We also recognize that historically County Council intended to limit BIT independence by requiring it to operate as a County agency. However, significant problems recently in the corporate and non-profit sectors suggest that policy-makers may wish to rethink governance issues and be more proactive in ensuring greater organizational independence, accountability, and transparency.

Over-reliance on ex-officio trustees has sometimes called into question potential conflicts or the appearance of conflicts on issues such as the use of trust funds for administrative expenses including the decision to relocate board offices and the allocation of personnel for plan administration. While our proposal to rebalance the board is modest and would not completely resolve potential conflicts or the appearance of conflicts, it would help by providing three independent trustees to form an audit committee or the majority of an audit committee as we recommend in finding no. 18.

Recommendation:

The BIT should ask County Council to amend MCC §33-59 to provide in sub-section (b)(2) for a decrease in the number of ex-officio trustees from four to three, to provide in sub-section (b)(3)(D) that the representative of Council be an individual not otherwise affiliated

with the County who is knowledgeable in pensions, investments, or financial matters, and to provide in sub-section (b)(3)(E) two individuals not otherwise associated with the County who are knowledgeable in pensions, investments, or financial matters. This result would increase the number of independent trustees to three, reduce the number of ex-officio trustees from four to three, and provide a balance among the trustee groups (ex-officios, retirement system members, and independent trustees) without changing the total number of trustees.

Agency Response:

This finding is a matter for the County Council, not the Board.

The Board's current membership reflects a legislative history of decisions carefully crafted by the Council in 1987. The Board includes representatives of active and retired plan participants, participants represented through collective bargaining agreements, County citizens, and senior management from the Executive and Legislative branches. Ex-officio members comprise 44% of the Board's membership, compared to 30% in Fairfax County, 63% in Baltimore County, and 100% in Prince George's County.

All members, when appointed to the Board, sign the Trust Agreement acknowledging they are a fiduciary and as such have the responsibility to administer the affairs of the Trust with care, skill, prudence, and diligence, solely in the interests of participants and their beneficiaries. As fiduciaries, all Board members have the responsibility to become informed on issues and to make independent decisions on matters related to the investment programs of the retirement plans. All pension fund boards operate in this fashion.

The report speculates that non-ex officio Board members "may not have fully exercised their overall fiduciary responsibilities," but OIG does not present any factual evidence to support this serious claim. Instead, once again OIG uses excerpts from "confidential" interviews with trustees, where the question, respondent, and context are unclear, that add no value. The report also speculates that "over-reliance on ex-officio trustees has sometimes called into question potential conflicts or the appearance of conflicts." This too is a strong statement, but OIG again fails to present any factual evidence.

OIG also fails to recognize that given the CAO's role by law as plan administrator, the Board's role in administrative matters is limited. The Board's chief focus, as its name suggests, is on the prudent investment of plan assets. It is worth noting that the Chair of the Board's Investment Committee has always been one of the Board's public members.

Given the serious (if unsupported) concerns it raises about the Board's composition, OIG proposes a remarkably modest remedy. It says that one of the four ex-officio trustees should go – it doesn't say which one – and one independent trustee should be added. Since the Board has historically acted by consensus on almost all matters, it is hard to see what practical difference such a change would make.

2.4.6 Require Prompt Transmittal of All Trust Funds

(Finding No. 12)

The BIT does not require the County to forward to the trust all retirement plan contributions promptly and in-full. MCC § 33-59(a) states, "The Board of Investment Trustees is established to manage the trust under this Article." Payroll deductions for retirement purposes should become assets of the trust fund when they are taken from members/participants. Trustees should exercise control over the use of trust assets promptly.

Payroll deductions are made on a pay-period-by-pay-period basis for each employee. The County's contributions are calculated monthly. County policy on remitting retirement plan contributions to the BIT has changed over the years. Initially, the County remitted contributions to the trust fund's bank account on an annual basis; later, remittance was made quarterly. Currently, County policy is to remit contributions monthly but to retain a minimum balance of \$500,000 at all times. The retained funds are used to pay plan administration expenses. The County routinely pays administrative expenses from the retained funds without direct BIT review of specific expenses.

The County policy of retaining retirement plan contributions and using those funds to pay administrative expenses is unnecessary and weakens the BIT fiduciary responsibility to control trust assets. While the CAO has the authority to incur and pay plan administration expenses, the BIT has the fiduciary responsibility to oversee the trust. Current County practice hinders the trustees in their duty to exercise control of trust assets. The BIT annual review and approval of the retirement plan budgets, in broad categories, is not an acceptable substitute for the review and approval of payment of specific administrative expenses as they are incurred during the course of the fiscal year.

The County and BIT should strive for complete transparency in handling trust funds. The BIT strongly believes the current policy regarding the holding-back of \$500,000 in trust funds by the County is well within the law, a point we do not dispute. However, we believe the better practice would be for the County to remit retirement plan contributions to the custodial bank promptly without retaining any funds. The County could request reimbursement from the BIT for administrative expenses on a regular basis. The BIT could then review the expenses and authorize the transfer of necessary funds to the County. While this process might be slightly less efficient than the current practice, the benefits of increased transparency and accountability would more than outweigh any possible reduction in payment efficiency.

Recommendation:

The BIT should arrange with the County to have:

- all plan contributions transferred to trust bank accounts promptly;
- detailed contribution collection and deposit information forwarded to the BIT for reconciliation;
- the County end the practice of retaining plan contributions; and

• the County invoice the BIT for reimbursement of all plan expenses.

Agency Response:

We do not concur with the finding about transmittal of trust funds. In our view OIG's analysis is inaccurate and has no basis in law.

Section 33-39 of the Montgomery County Code governs member contributions to the System. Section 33-40 governs employer contributions to the System. Members contribute to the System through regular payroll deductions, and the prompt transmittal of those deductions to the trust is not regulated by the Internal Revenue Code or the Montgomery County Code. Members receive a benefit that is based on a formula and on the contractual obligation of the County to pay the benefit, regardless of plan funding or transmittal of trust funds. Section 33-40 governs employer contributions and requires that "[t]he County and each participating agency must pay the board each fiscal year a normal contribution, and, if necessary, an additional contribution to be known as unfunded accrued liability contribution." Thus the assertion that contributions are not "promptly" made to the Trust is erroneous. In fact, the County is actually making monthly contributions to the trust, well in advance of what is required by law.

OIG cites Section 33-59 (a) of the Montgomery County Code, which states, "[T]he Board of Investment Trustees is established to manage the trust <u>under this Article</u> [.]" (emphasis added), and infers from that statement that all of the fiduciary duties to manage the trust inure to the Board, regardless of whether fiduciary duties have been delegated to another as required under Article III of the Employees' Retirement System.

Article III requires the Board to delegate fiduciary duties to investment managers, and the enabling legislation of the retirement law has delegated the fiduciary responsibilities associated with plan administration to the CAO under Section 33-47 (a). This section states, "[T] he chief administrative officer shall be responsible for the administration of the retirement system." Sections 33-59 (a), which establishes the Board to manage the trust as required under Article III, does not "trump" or diminish Section 33-47 (a), which delegates the administration of the system to the CAO. OIG shows a misunderstanding of fiduciary law.

In conclusion, with regard to recommendations on:

- Transferring all contributions "promptly"- This is already being done in accordance with the Internal Revenue Code and the Sections 33-39 and 33-40 of the Montgomery County Code. In addition, a Memorandum of Understanding in FY 2002, approved by the Director of Finance, custodian of the plan assets, and reviewed by the Board, accelerated the timing of contributions to the System to preclude the need to liquidate assets to pay benefits.
- Reconciling contribution information Detailed contribution collection and deposit information is already being forwarded to the Board for reconciliation.

- The County ending the practice of retaining plan contributions This recommendation conflicts with the Internal Revenue Code and Sections 33-39 and 33-40 of the Montgomery County Code.
- The County invoicing the Board for all plan expenses This would contradict provisions in the plan's enabling statute that allocate fiduciary duties and liabilities and would unnecessarily increase the costs of the plan.

2.4.7 Seek Greater Trustee Responsibility for Staff and Consultants (Finding No. 13)

The trustees do not exercise direct control over staff and consultants who play critical roles integral to sound management of the trust. The BIT executive director, independent auditor, and actuary are not hired by the trustees, do not report directly to the trustees, and are not responsible to the trustees for the faithful performance of their professional duties. The executive director and the actuary are appointed by the CAO. The independent auditor is appointed by the County Council. Staff and consultants provide critical support to the BIT in managing the trust; but the current set-up for selection and the resulting reporting lines create a situation in which these key advisors serve two masters with the potential for competing and possibly conflicting interests. For example, although the CAO has fiduciary responsibilities with regard to trust funds, his duties and responsibilities for County government go beyond those to the trust, i.e., negotiating collective bargaining agreements and balancing the County budget. The executive director and the actuary, in advising the BIT but reporting to the CAO, could be confronted with conflicting loyalties.

After its founding, the BIT attempted to establish its own staff. At a meeting on July 31, 1987 the BIT discussed a resolution:

... that the Board request that the County establish and fill a position of Executive Director of the Board of Investment Trustees in accordance with the procedures outlined in the County Attorney's memo. The Board intends that this position report to the Board and that only incidental non-Board management responsibilities be assigned. The motion passed without objection.

However, the BIT did not establish its own staff. Instead we have the current organizational structure. Staff and the consultants should not be placed in the position of trying to balance the competing roles of County agency and independent fiduciary.

The BIT has told us that legally the current practice must continue. We believe the changes we are recommending can be made within the confines of the current law. All we are recommending is that the BIT ask the County administration and the County Council to work with it in strengthening management controls.

Recommendation:

The BIT should ask the CAO to consider entering into a memorandum of understanding in which the CAO would delegate to the board authority for the selection and supervision of the executive director and actuary.

Further, the BIT should ask County Council to consider entering into a memorandum of understanding in which the County Council would allow the BIT to recommend to it the hiring of an independent auditor to audit the financial statements of the trust funds.

Agency Response:

We do not concur with the finding that the Board should seek greater trustee responsibility for staff and consultants.

Section 33-51(c) of the Montgomery County Code requires that a complete and independent audit of the retirement system be made annually by the firm of certified public accountants under contract with the Council pursuant to Section 315 of the Charter. By law the Council confirms the appointment of the trustees to the plan and must satisfy itself that the Board and the trustees are performing their required duties. The Council does so through the annual independent audit, the CAFR, and quarterly reports submitted by the CAO as required by law.

The current process legally must continue to ensure that the Council is monitoring the fiduciaries and can ensure that the fiduciaries are performing their duties. If the Board hired a separate firm to audit the plans, the County's auditor would still need to review the work. The result would be additional cost to the plans with no additional assurance or independence.

Sections 33-60 (d) (12) and 33-125 (d)(12) of the Montgomery County Code give the Board the authority to hire its own auditor (as it has done in the past to audit various aspects of the plans) and its own actuary solely to perform Board services. Thus there is no need for the Board to enter into a Memorandum of Understanding with the Council or the CAO.

The executive director's position is a merit position, as defined in the Charter. As such it cannot report directly to the Board and reports instead to the CAO. The Board works cooperatively with the CAO to oversee the work assigned to and performed by the executive director and in preparing the annual performance appraisal.

2.4.8 Acquire the Services of a Full-Time Staff Accountant (Finding No. 14)

The BIT does not have the services of a full-time staff accountant reporting to the executive director on a daily basis. The responsibilities of the BIT are vast and far-ranging. It annually invests nearly \$2 billion, oversees the maintenance of records for over 18,000 active members or participants, manages 18 contracts for professional services, supervises an annual administrative budget of more than \$2.3 million including the payment of a portion

of salaries and benefits for more than 30 people, and publishes its own CAFR. To effectively and efficiently carry out its many financial responsibilities, the BIT needs a full-time accountant.

We understand the BIT has been working on a reorganization of staff which includes the creation of an accountant's position. The reported corrective action taken or planned is duly noted and the BIT is commended for those actions. However, according to generally accepted government auditing standards, corrective action taken or planned during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

The board admits that an accountant in Finance is being paid 100 percent with trust funds, but does not spend 100 percent of his time working on trust fund issues, but that others in Finance work on trust fund issues for which the trust is not charged. The board suggests that this arrangement is appropriate because it is "used widely." As we mentioned before, under the Internal Revenue Code and County law, trust funds should be used for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of the plans, and no part of the trust funds should ever inure to the benefit of the County. (Emphasis added.) Ensuring that trust funds are used for the exclusive purpose of defraying reasonable expenses requires, at a minimum, a methodologically-sound cost allocation plan supported by adequate documentation. In addition, the board maintains that our view that an accountant for the board can be funded without additional cost to the trust funds "is not valid" without offering any evidence as to why that is so.

Recommendation:

The BIT should obtain the services of a full-time accountant working under the supervision of the executive director. This should be accomplished without increasing the overall expenditure of trust funds by having the new BIT staff accountant perform the accounting functions currently performed by the accountant in Finance.

Agency Response:

We concur in part. As noted in our response to finding #7, the Board has already acted to create the accountant position as part of a staff reorganization that began in 2001. OIG is endorsing our action. We do not agree with OIG's view on funding the position.

The accountant in Finance does not work for the Board and does not spend 100 percent of his time working on retirement plan matters. His time is reflected as an "FTE" (full-time equivalent) representing the proportional time spent by several Finance employees on retirement plan matters. The FTE concept is used widely in this way. The Finance Department staff perform many accounting functions for the retirement plans, not for the Board. These functions, such as reconciliation and transmittal of contributions, disbursement of benefits, and preparation of tax statements, need to be segregated from the Board's operations for internal control purposes.

OIG's view that the accountant position on the Board staff can be paid for by simply transferring the functions currently performed by the accountant in Finance, or taking the funding for it, is not valid. By that logic funding for any position could simply be "transferred" from a different office without cost.

2.4.9 <u>Improve Staff Responsibility for Contract Administration</u> (Finding No. 15)

At the time we began our audit the BIT had not assigned responsibility to staff to oversee contract administration. As a result, there were lapses in contract obligations. The BIT manages 18 contracts, primarily professional services contracts with its investment managers and custodial financial institutions. While the board is exempt from the provisions of the County's procurement regulations, it is not relieved of responsibility to follow sound business practices in the area of contract administration.

Some significant BIT contracts were not updated in a timely manner. One major service provider proposed modifications to the terms and conditions of its "Disbursements Contract." The BIT did not appropriately respond to the proposed modifications leaving the vendor to recover fees or other advantages accruing from its proposal. In another instance, the record-keeping contract with a service provider expired, and although the BIT did not extend or update the contract, BIT continues to use the services under that contract. In one case BIT staff discovered that a service provider had overcharged \$166,000 in fees and the amount was recovered.

The BIT reports that contract administration responsibility has been delegated to the executive director. The reported corrective action is duly noted and the BIT is commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

Management controls are designed to ensure execution of transactions and events are to be authorized only by persons acting within the scope of their authority, such as vendors operating under the terms and conditions of a properly executed valid written contract. At the time we began the audit, BIT practices were inadequate to ensure contracts were adequately monitored, updated, or renewed in a timely manner.

Recommendation:

The BIT should periodically review its contract administration policies and procedures and assign staff responsibility for contract administration to ensure that contracts are regularly reviewed for performance and updated or renewed timely.

Agency Response:

We do not concur with the finding that the Board needs to improve staff responsibility for contract administration.

The Board's contract administration responsibility has always been delegated to the executive director. The report's statement that the Board took corrective action to delegate contract administration to the executive director is incorrect. The report's statement that the "disbursements contract" used for the payment of benefits is unilaterally increased in cost without Board oversight fails to take into account the oversight process the Board employs annually to review expenses associated with the plans. During the annual budget process the Board reviews the services provided under the disbursements contract, and the cost-of-living type increases associated with it, to determine the reasonableness of the increases.

As to expired contracts, the Board requires all current service provider contracts to be terminable at will, rather than ending at a specific date, consistent with current practice in employee benefits contracts. In September 2002 Board staff discovered a problem with a service provider contract related to the contract expiration date and the fees being charged. The vendor reimbursed the plan and participant accounts for the amounts overcharged.

2.4.10 Ensure Government Auditing Standards are Followed (Finding No. 16)

The BIT audit reports do not conform to generally accepted government auditing standards (Yellow Book, also known as GAGAS). For financial years 2000, 2001, 2002, and 2003 the independent auditor's reports published in the board's CAFR do not contain a report on internal controls, or a reference to other documents that contain such report. Assessing the adequacy of internal controls is a necessary part of any government audit performed in accordance with Yellow Book, the "gold standard" in government auditing.

The County's contract with the independent auditor requires audits to be performed in accordance with Yellow Book standards. (§II, bullet 3, p. 15). A later amendment to that contract called for an audit of retirement system financial statements. (Contract Amendment #1). A clause in the amendment states, "Existing contract terms remain in effect unless specifically changed by this amendment." (Emphasis added). There is nothing in the amendment specifically removing the requirement in the contract that audits be performed in accordance with GAGAS. Therefore, it is our conclusion as auditors that those standards pertain to the amendment regarding the audit of BIT financial statements.

Yellow Book standards state, "The report on the financial statements should either (1) describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or (2) refer to separate reports containing that information." (Government Auditing Standards, §5.15). We believe it is important to apply generally accepted government auditing standards which require a separate report on management controls to the retirement system audit because our audit and prior reviews have noted several significant management control problems.

In the introduction to the board's CAFR the CAO states, "The Plans' Management is responsible for maintaining internal accounting controls to provide reasonable assurance that transactions are properly authorized and recorded as necessary to permit preparation of

financial statements in accordance with accounting principles generally accepted in the United States of America. We believe the internal controls in effect during the fiscal year ended June 30, 2002, adequately safeguard the Plans' assets and provide reasonable assurance regarding the proper recording of financial transactions." The CAO's statement on internal controls does not satisfy generally accepted government auditing standards requirements.

MCC §33-51(a) requires "A complete independent audit of the retirement system shall be made at least annually by the firm of certified public accountants under contract by the county council for the purpose of implementing Article III section 315 of the charter of the County. The complete audit shall be filed with the county council and copies thereof shall be made available to the public and open to public inspection."

Because the CAFR is a public document, members/participants of the retirement plans and the general public may have erroneously concluded that the statement of assurance about internal controls provided by the CAO constituted adequate audit coverage.

Recommendation:

The BIT should ensure that future independent audits of the board's financial statements are done in accordance with generally accepted government auditing standards.

Agency Response:

We do not concur with the finding that appropriate audit standards were not followed. The Board supports the use of proper audit standards and has issued reports based on those standards.

The report states that the Council's contract with the independent auditor requires audits to be performed in accordance with Yellow Book standards (Government Auditing Standards or GAGAS), and references Section II, bullet 3, p. 15 as support for that assertion. That reference relates to the Section C.II of the Office of Legislative Oversight's (OLO) Request for Proposal (RFP) for audit services dated August 6, 1999 (Attachment B to the Council's contract for audit services).

RFP Section C.I, Scope of Services lists all audit services to be performed and reports to be issued by the external auditor. Section C.II, Accounting and Auditing Standards, states: "The audits, will be conducted in accordance with the following accounting and auditing standards, as applicable (emphasis added)." This section includes auditing and accounting standards that may be applicable to any, not all, of the services provided by the external audit firm. For example, Audit Guidelines for examination of 9-1-1 Trust Funds only applies to the audit of the Enhanced 9-1-1 Trust Funds (Section C.I Item C). The RFP does not specify which accounting and auditing standards listed in the RFP Section C.II would apply to any audits added under contract amendment. That information would be designated in the approved contract amendment.

The only services under RFP Section C.1, Scope of Services that are required to be performed in accordance with Yellow Book Standards or GAGAS are those that relate to the Single Audit Act (Section C.I Item A.4, Single Audit Act). The County CAFR is required to be audited under these standards because the County receives federal funds.

The audit of the retirement system was added to the scope of the Council's contract through Amendment #1, as Article I, Item D. The stand-alone financial statements of the retirement plans (BIT CAFR) are not required to be audited under GAGAS, since: 1) the retirement plans do not receive federal funds (making the single audit act and A133 not applicable), and 2) the contract amendment that provides for the audit of the BIT CAFR does not require an audit under GAGAS.

This is consistent with paragraph 1.1 of the Government Auditing Standards, which contains standards for audits of government organizations. These standards are to be followed by auditors when required by law, regulation, agreement, contract, or policy. This is also consistent with the language in the body of the contract, the General Conditions of Agreement between County Council and Auditor (Attachment A to the contract), the auditor's Proposal (Attachment C), and the annual engagement letter between the audit firm and OLO, which is signed by the contract administrator.

In the body of the contract, the only reference to reports on internal controls and compliance falls under the Background Section under 1.A.2 Single Audit Act, which is consistent with the RFP Section C.I Item A.4. The General Conditions of Agreement between County Council and Auditor (Item 2, Audit Services), which applies to the entire contract, requires that the audits be conducted "in accordance with generally accepted auditing standards" (GAAS). There is no general term or condition that any and all audits be conducted in accordance with Government Auditing Standards.

In the auditor's Proposal, references to Government Auditing Standards and reporting on internal controls are made under the section entitled Technical Approach — Single Audit. The annual engagement letter between OLO and the audit firm (dated May 22, 2003 for the FY03 audits), page 1, refers to Government Auditing Standards only in relation to the County audit; the audit of the retirement plans and the 911 system audit are to be performed in accordance with GAAS. On page 3, it is noted that a written report on internal control and compliance, in accordance with Government Auditing Standards, will be provided as part of the audit of the County's financial statements.

It should be noted, however, that the pension plans included in the BIT CAFR are also included in the County CAFR as a pension and other employee benefit trust fund. Since the audit of the County CAFR was conducted under GAGAS, because the County received federal funds, a report on internal controls was issued as a result of that audit, and the County's CAFR contains a reference to that point.

In conjunction with OLO's execution of a new contract for the audits of the FY 2004 financial statements, BIT and OLO will work to ensure that the contract document is as

clear as possible with regard to the standards under which the retirement audit is to be performed.

2.4.11 Exercise Reasonable Care in Preparation of CAFR

(Finding No. 17)

Administrative expenses reported in the board's CAFR do not match actual administrative expenses. Each year from FY 1998 to FY 2003 administrative expenses as reported in the CAFRs have been understated (in several of the years investment expenses were overstated by the amount that administrative expenses were understated). The understatements have totaled \$1,523,822 over the six-year period as follows:

Fiscal Year	Reported	Actual	Understatement
1998	\$1,223,170	\$1,489,305	\$ 266,135
1999	\$1,339,515	\$1,619,037	\$ 279,522
2000	\$1,318,334	\$1,740,662	\$ 422,328
2001	\$1,799,491	\$2,145,170	\$ 345,679
2002	\$2,228,545	\$2,292,612	\$ 64,067
2003	\$2,234,691	\$2,380,781	\$ 146,090
Total	\$10,143,746	\$11,667,567	\$1,523,821

Administrative expenses were understated by 15.0 percent overall during the six-year period (10.4 percent for the ERS, 52.8 percent for the RSP, and 154.6 percent for the DCP). The BIT maintains the understatements were immaterial to its financial statements as a whole and that the problem was corrected in its FY 2002 CAFR. While it may be true that the misstatements were immaterial to the financial statements as a whole, the misstatements were material to total administrative expenses and we detected misstatements in the FY 2002 and FY 2003 CAFRs as well.

The CAFR is the authoritative statement of the financial position of the BIT and should be as accurate as practicable. An inaccurate CAFR can be unintentionally misleading. Readers of the CAFR include elected officials, employees, financial analysts, and the public.

BIT management and its independent auditor did not reconcile differences in administrative costs. Although it appears to us that the differences were mostly the result of unintentional misclassification, the outcome can have important repercussions. For example, an understatement of administrative costs can cause a skewing of any benchmarks or ratios calculated using the erroneous information.

Recommendation:

The BIT should strengthen efforts to exercise reasonable care in the preparation of its financial statements, particularly with regard to reporting administrative expenses, and ensure that management reconciles any differences before the CAFR is published.

Agency Response:

We do not concur with the finding that the Board did not exercise reasonable care in preparing the Retirement Plans' CAFR. The Board exercised the highest standards of care in its review, preparation, and presentation of the CAFR and has the proper controls in place to identify errors.

The Statement of Plan Net Assets and Statements of Changes in Plan Net Assets as shown in the Retirement Plans' CAFR are correct in total, but for FY 1999, 2000, and 2001 administrative expenses were misclassified as investment expenses. When Board staff discovered the error during the preparation of the FY 2001 Retirement Plan CAFR, it was corrected. All future payments have been processed correctly, as reflected in the FY 2002 CAFR.

The Board and the County's Controller's office consulted with the external auditors at the time the misclassification was discovered and considered the appropriateness of re-issuing the statements. Since the relationship of the misclassified dollar amount to the overall statements was immaterial, and since the statements reported the correct total dollars of expense, the external auditor's conclusion was that re-issuing the statements was not necessary.

OIG's assertion that the administrative expenses shown in the FY 2003 CAFR are incorrect is in error. The administrative expenses shown in the FY 2003 CAFR for the three retirement plans reflect what was paid from the trust funds. As Board staff has explained to OIG, administrative expenses related to the Deferred Compensation Plan are paid from the General Fund Non-Departmental Account. This is clearly stated in the County's Approved Budget and the County's CAFR. The Board will revise the footnotes of the Retirement Plans' CAFR in 2004 to add similar language.

2.5 Follow-up from Prior Audits

In this section we evaluate the efficiency and effectiveness of follow-up from prior audits. Much of the benefit from audits is not in the findings and recommendations themselves, but in their effective resolution. Guidance in this important area comes from GAO audit standards which require prompt resolution of audit findings and recommendations. To comply with the resolution standard, management, which sets the tone at the top of any organization, is required to accomplish three things:

- promptly evaluate findings and recommendations reported by auditors or evaluators;
- determine the proper actions in response to audit findings and recommendations; and
- complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention.

In summary, action on recommendations, not the recommendations themselves, helps government work better; therefore, audit follow-up is a very important component of public accountability.

As we discuss below, during our fieldwork we reviewed four previous audits or evaluations of trust fund operations done at the board's request. By our count those reports contained a total of 126 recommendations. We identified a sample of 26 recommendations and asked the BIT to report on implementation status. The board's response indicated that trustees did not initially concur with one of the recommendations. The BIT further indicated that 13 of the recommendations required a response directly from the County. The responses we received from both the BIT and the CAO indicated full or substantial implementation of 14 recommendations (56.0 percent) and minimal implementation or no implementation with regard to 6 recommendations (24.0 percent). We did not independently verify the self-reported implementation status. We developed a grading scale based upon reported implementation status (full implementation = A, substantial implementation = B, moderate implementation = C, minimal implementation = D, no implementation = F). The overall grade given to the BIT was C+. (**Table 17.**)

Table 17. Self-Reported Implementation Status of Prior Audit Recommendations				
Crada	BIT		COUNTY	
Grade	Number	Percent	Number	Percent
A	5	41.6	4	30.9
В	2	16.7	3	23.0
С	2	16.7	3	23.0
D	1	8.3	1	7.7
F	2	16.7	2	15.4
Total	12	100.0	13	100.0

Source: OIG analysis.

The following sections 2.5.1 and 2.5.2 contain our findings and recommendations as well as the BIT responses regarding follow-up from prior audits.

2.5.1 Establish an Independent Audit Committee

(Finding No. 18)

The BIT does not have an audit committee. An audit committee for the BIT would function as an independent, accountable, and transparent "gatekeeper" for the trust, helping in board oversight of financial management and reporting of the trust activities. Despite the board's assertion that it "has strong internal controls and reporting mechanisms in place to deal with audit findings," during our fieldwork we saw firsthand or learned through reviewing the work of others, and have reported elsewhere in this report, various short-comings such as the following:

• all funds have not been transmitted to the trust in the most timely manner;

- key service contracts have not been timely reviewed and renewed;
- generally accepted government auditing standards have not been followed;
- administrative and investment expenses have been misstated in public reports;
- accounting and reporting controls for the safekeeping and disposal of office equipment were weak;
- budget oversight in important areas was inconsistent;
- a government-issued credit card was abused;
- ethics laws regarding outside employment were skirted by a former BIT administrator; and
- trust funds were wasted on excess office space and other unnecessary or questionable purchases.

Montgomery County prides itself on being a leader in good government and an audit committee is a "good governance" issue. Many public and private entities including the GAO, the SEC, and GFOA are stressing the need for greater accountability in the wake of financial scandals involving WorldCom, Tyco, and Enron as well as the mutual fund industry in the private sector; the United Way and the Washington Teachers Union in the non-profit sector; and Fannie Mae, Freddie Mac, and the Maryland Retirement System in the quasi-governmental area. An audit committee, while it provides no absolute guarantee, can provide the means for greater accountability.

The members of a BIT audit committee such as we are recommending would collectively possess knowledge of or experience in accounting, investments, auditing, and financial reporting needed to understand and resolve issues raised by reports from auditors, actuaries, and other professionals. The primary work of the audit committee would be to oversee the work of auditors, actuaries, and other professionals from their selection to the resolution of any issues raised in their reports. The audit committee would also serve as the focal point for implementing comprehensive audit and compliance review program recommended in finding no. 19. The audit committee would present an annual report to the board and the public on how it discharged its duties and met its responsibilities.

The BIT has told us that it did not accept some findings and implement certain recommendations from various professionals it employed in the past (including a recommendation to establish an audit committee) "because whatever their theoretical merit, they were not consistent with the Charter or County law." While we understand that changes in County law or the Charter can take time, it seems to us if those recommended changes have any merit, the BIT should pursue them with County Council or the charter review commission as appropriate. However, according to the board, our recommendation for an independent audit committee, which was also recommended in a previous report by an outside consultant hired by the BIT, could be implemented under its current by-laws.

Our system of managing public programs such as the BIT rests on a complex structure of relationships among various entities and levels of government. Officials and employees who manage these programs need to render a readily understandable account of their activities to the public. While not always specified by law, accountability is inherent in the governing

process of this nation. In addition, here we have the added fiduciary duty, the highest duty recognized under law.

Recommendation:

The BIT should consider amending its by-laws to provide for the establishment of an audit committee. Independent trustees should constitute a majority of the members of the audit committee with no more than one member from each of the other trustee groups: ex-officio and member/participant. An independent trustee should chair the audit committee.

Agency Response:

We do not concur that an independent audit committee should be established.

OIG's references to "financial scandals" at Tyco, Enron, and WorldCom — all of which by the way had audit committees that apparently did not do them much good — and other entities like the Maryland state pension fund are off target. Those corporate boards grossly breached their fiduciary duty, which the Board would never do. The Maryland state fund did not have an independent investment consultant as a fiduciary; the Board does.

The Board has strong internal controls and reporting mechanisms in place to deal with audit findings. These include an automated system to monitor investment manager compliance with guidelines and policies, quarterly budget versus actual expense reports for all three retirement plans, and a monthly workplan detailing future action items, projects, and activities.

The report lists "shortcomings" that OIG thinks an audit committee could address. The list actually reflects the Board's strong internal controls and reporting mechanisms. For example, the key service contract issue was found by Board staff as part of their due diligence review of a payment. The misclassification of administrative and investment expenses was again found by Board staff as a part of the internal control review prior to issuing the CAFR.

The Board's by-laws permit it to establish ad hoc committees if they are needed. Many corporate boards are finding it hard to identify "experts" for their audit committees. Most local pension plans, such as those in Fairfax, Arlington, and Frederick, do not have audit committees for that reason. As a practical matter, it would require a wholesale change of membership on the Board to create an audit committee comprised of members with expertise in "accounting, investments, auditing, and financial reporting," as OIG proposes.

In section 2.5 OIG says that some findings from prior audits were not implemented. This is a problem only if all the findings were valid to begin with; OIG provides no analysis on this point. (Actually, table 17 shows that the Board has fully or substantially implemented nearly 60% of prior audit findings.) The Board did not implement some findings in the audit we requested from a national consulting firm, for example, because whatever their theoretical merit, they were not consistent with the Charter or County law and the Board did not

believe that changes were warranted. Similarly the Board does not concur with most findings of this OIG audit. Table 17, which lists implementation of prior audit findings, is therefore a mathematical exercise, not a substantive one.

2.5.2 Establish Regular Audit and Compliance Review Program (Finding No. 19)

The BIT does not have an adequate audit and compliance review program. While the financial statements of the BIT are audited annually, the purpose of a financial statement audit is limited to assuring users that those statements, which represent management's assertions concerning the finances of the BIT, are fairly presented. A comprehensive audit and compliance review program goes beyond a financial statement audit and helps an organization ensure that management controls are well-designed, properly implemented, and adequately maintained. According to the GFOA and other professional groups, a formal audit and compliance review program is particularly valuable to an organization such as the BIT whose activities involve a high degree of risk (e.g., complex accounting systems involving numerous participants and transactions, multiple contracts with outside parties, a rapidly changing environment).

During our fieldwork we reviewed previous audit reports containing 126 findings relating to BIT activities. Some of the findings pointed to the need for a more systematic review process. The findings support the need for an independent, audit and compliance review program to:

- determine whether contributions within the limits of those allowed by the IRS were made by participants of the deferred compensation plan;
- examine the accuracy of invoices, disbursements, and annual fee charges submitted by service providers;
- verify and reconcile the accuracy, timing, and completeness of income and dividends receivable;
- examine the securities lending program, including calculations of income, fees, and compliance with lending and investment guidelines;
- test whether the retirement database contains sufficient, accurate data for the purposes intended (e.g., retiree and joint beneficiary birth dates, average final earnings, pension benefit calculations, accrued sick leave, addresses and address changes);
- review service provider benefit payments and COLA adjustments;
- monitor the controls of service providers through examination of independently audited financial statements and internal control reports, SAS 70 reports, SEC filings, and discussions with service provider management to ensure assets invested are properly recorded and safeguarded; and
- assess the accuracy and appropriateness of any lump-sum distributions.

The County and the BIT have hired auditors and evaluators from time-to-time to perform various reviews of BIT operations. However, aside from the annual audit of financial statements, no such reviews have been undertaken in the past several years. A regular, compre-

hensive audit and compliance review program is an essential ingredient that helps an organization in two important ways: by minimizing risk of loss and by enhancing management controls.

Recommendation:

The BIT should establish a regular, comprehensive audit and compliance review program to oversee audits and track the implementation of audit recommendations. To be effective such a program does not need to be large or expensive, but it should be on-going. The program can be provided by outside auditors chosen on a competitive basis by and reporting to a BIT audit committee.

Agency Response:

We do not concur that a regular audit and compliance review program needs to be established. The Board has effective audit and compliance programs in place.

This finding leaves the incorrect impression that the Board and the CAO lack strong controls. As specified in the law, and as noted in our earlier comments, both the Board and the CAO have discretion to hire actuaries, auditors, and other service providers for the administration of the plan, and solely to carry out either Board or administrative functions. The Board has repeatedly done this. Recent examples include:

- hiring external auditing firms to review programs, such as the Deferred Compensation Plan;
- contracting with national consulting firms to review Board operations; and
- requesting the Council to have their auditors review the Board's Comprehensive Annual Financial Report on the retirement plans.

The Board recently completed implementation of recommendations proposed by the national consulting firm review. For the past 20 months Board staff has focused on responding to audit requests from OIG related to this report.

The Board has a comprehensive set of Investment Guidelines and Policies, including a Proxy Voting Policy, Funding Policy, Derivatives Policy, a Rebalancing Program, and a Risk Management Position Statement, which were designed to safeguard plan assets. Each investment management agreement specifies the investment guidelines with which the manager must comply, including the types of securities that are eligible for investment. This is another consistent practice in allocating and delegating fiduciary duties among and between investment managers and the Board. Board staff monitors compliance with the Board's policies by each investment manager and recommends replacement of managers if appropriate.

2.6 Fraud, Waste, and Abuse Investigation

In this section we report on an investigation we conducted into allegations of fraud, waste, and abuse by the former director of pension investments (the current position title is executive director), who was employed by the County between 1995 and 2002, involving the expenditure of trust funds of the retirement plans. The purpose of the investigation was to determine whether the former director acted properly in discharging his fiduciary responsibilities handling retirement plan trust funds and fulfilling ethical obligations consistent with County regulations and policies.

Initially, while working on a previous review of travel and expense card use by County employees we had occasion to examine the activities of the former director with respect to his use of a travel and expense card. That review identified transactions which caused us to question the manner in which the former director conducted business. We also received information from confidential sources raising questions about other instances of improper conduct by the former director. Based on our own preliminary observations and the other allegations we received we conducted a more thorough review of the activities of the former director and concluded that he had engaged in a course of conduct that violated the public trust. We informed the CAO of the results of our investigation and he acted quickly to remove the director. We also referred the matter to the state's attorney.

The former director began his service with the BIT as senior investment officer in May 1995 and was promoted to director of pension investments by the CAO in May 1999. The former director reported to the CAO, who was his immediate supervisor and responsible for evaluating his annual performance, although day-to-day supervision of the former director was generally handled by the BIT chairman, an ex-officio member of the board.

Our findings include the following with questioned costs totaling \$51,765:

- fraud, waste, and abuse in the amount of \$11,536 involving the misuse of a County travel and expense credit card;
- waste and abuse in the amount of \$20,177 involving the overpayment of employee development and educational expenses; plus an additional \$10,882 in pro-rated reimbursements;
- fraud, waste, and abuse in the amount of \$9,170 involving the improper reimbursement of personal expenses;
- failure to fully comply with ethics law provisions; and
- inadequate supervision of the former director.

In addition, the former director did not demonstrate the personal integrity expected of County employees as defined by the County's ethics law and the County Executive's Vision Statement and Guiding Principles. Those public policy pronouncements require employees to adhere to the highest ethical standards and to be accountable for official actions.

The BIT reports that appropriate reimbursements to the trust were ordered by the CAO in November 2002. We have been able to verify that reimbursements totaling \$30,499.81 from the County to the trust were made in August and November 2003. An adjusting journal entry posted the reimbursements as of June 30, 2003. The County has also established an "accounts receivable" from the former director of pension investments to cover what has actually been reimbursed and what is owed. The reported corrective action is duly noted and the BIT and the County are commended for taking that action. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation.

Statements by the BIT implying that Finance's internal audit section (IAS) began an audit of the activities of the former director of pension investments in June 2002 and completed work on that audit during the fall of 2002 do not fit with our clear understanding of the reality of the situation. In fact, when we reported the results of our preliminary investigation regarding the former director to the chairman of the board and the CAO in early August 2002 both expressed what we perceived to be genuine shock and dismay at the unfortunate news. Additionally, the internal audit section told us its audit was not started until August 2002 and was not completed until April 2003. We believe coordination and cooperation between our office and IAS was exemplary on the part of both entities, but the OIG investigation was the impetus for the IAS audit.

Management controls, including the County's ethics law and the County Executive's Vision Statement and Guiding Principles, are designed to provide reasonable assurance that resources are used consistent with agency mission; that programs and resources are protected from fraud, waste, and abuse; and that regulations and procedures are followed. General management control standards require personnel to demonstrate a positive attitude toward management controls and have personal and professional integrity. Specific standards require that accountability for the use of resources is assigned and maintained; that transactions are authorized and executed only by persons acting within the scope of their authority; and that qualified and continuous supervision is provided to ensure management control objectives are met.

In this case the former director did not demonstrate the personal integrity expected of all County employees; controls did not identify improper reimbursements for personal expenses or excessive educational benefits being directed to a single individual; and supervisors were not vigilant in identifying "red flags" raised by improper and unethical behavior.

The following sections 2.6.1 through 2.6.5 contain our findings and recommendations as well as the BIT responses regarding our investigation.

2.6.1 Ensure Reimbursement for Improper Credit Card Expenses (Finding No. 20)

The former BIT director of pension investments violated County policy by using a County-issued travel and expense credit card to conduct unauthorized transactions. Policy on the use of the travel and expense credit card clearly stated that the card could be used "only for

official County business." To further emphasize use restrictions, each employee issued a credit card executed an <u>Employee Acknowledgement Agreement</u>, which also stated that use of the card was "only for actual and necessary business expenses."

We reviewed 60 monthly account statements for the credit card issued to the former director. The monthly statements covered the period from April 1997 to March 2001. An analysis of the account identified numerous transactions that were not readily recognizable as official business or were unnecessary or unsupported business expenses. The questioned expenditures consisted of the following actions by the former director:

- conducting "cash advance" transactions and diverting \$5,950 of the proceeds to personal use (the "cash advance" transactions consisted of 8 separate transactions, ranging from \$250 to \$1,500 between May 2000 and August 2001);
- making repeated purchases for personal benefit in the amount of \$2,681 (the
 personal purchases consisted of over 65 separate transactions and included such
 items as meals, golf, bowling, gas, car washes, dry-cleaners, children's toys, and
 books);
- making unnecessary business purchases in the amount of \$2,061 (the unnecessary and unreasonable business purchases included cell phone accessories, computer software and accessories, parking fees, and books); and
- incurring unnecessary bank fees (finance charges, late fees) in the amount of \$844.

The questioned charges totaled \$11,536. Further, having charged thousand of dollars worth of personal expenses on the BIT credit card account, the former director frequently failed to reimburse in a timely manner.

Recommendation:

The BIT should ensure that the trust is reimbursed \$11,536 for improper credit card expenses incurred by the former director. In addition the BIT should take steps to reinforce individual responsibility for any future use of credit cards by trustees and employees by ensuring that credit card procedures limit the ability of trustees or employees with County-issued credit cards to conduct "cash advance" transactions and provide for close monitoring to ensure that no such transactions by trustees or employees take place.

Agency Response:

We concur in part. Appropriate reimbursements to the trust have already been made. County credit cards have been replaced by P-cards, which have tight controls and do not permit cash advances. OIG's chronology of events and statement of amounts to be reimbursed are only partly accurate.

First, as to chronology, in June 2002, in response to several "red flags" that had come to his attention, the CAO asked the Finance Department's Internal Audit Section to review all expenditures by the then-director. In August 2002 OIG informed the CAO of two "red

flags" from its own preliminary investigation. Also in August 2002 Internal Audit started to list disallowed expenses. In September 2002 the then-director resigned, and the CAO stated that full reimbursement to the trust would be required for any improper expenses. During the fall of 2002 Internal Audit completed its preliminary report. In November 2002 the County Attorney began the process of securing reimbursement to the trust, starting with withholding payment for accrued annual leave. That entire process is complete.

The report describes the cooperation between Internal Audit and OIG as "exemplary." The report also calls OIG's investigation the "impetus" for Internal Audit's investigation. As noted above, however, the investigations were not sequential but parallel.

Second, as to amounts to be reimbursed, Internal Audit's report was exhaustive and included detailed schedules of expenditures. Internal Audit shared its schedules with OIG. OIG did not reciprocate with its schedules. (OIG said in its October 2003 annual report that it "coordinated its investigative activities with the State's Attorney's Office and the Department of Finance Internal Audit Section.")

Internal Audit's final number for disallowed costs for all items (credit card use, tuition, non-local travel, and cell phone use) was \$28,460.94. (Half of this amount, \$14,181.00, was the prorated reimbursement for MBA tuition that any employee who did not remain with the County for the required time would have had to make.) With accrued interest of \$2,038.87, the amount to be reimbursed to the trust was \$30,499.81. OIG used Internal Audit's numbers and then added to them, first by questioning credit card charges that the then-director himself had already paid directly to the credit card company, and second by categorizing job-related investment seminars as subject to the annual \$9,000 ceiling on employee development. Internal Audit does not agree with OIG's additions. Neither does the Board.

The events leading to the Internal Audit review clearly should never have taken place. All County employees are expected to respect County values and procedures at all times. For senior managers in particular, as the report says, the expectation is that they will "adhere to the highest ethical standards."

Today, one and a half years after the then-director's resignation, three essential facts are clear:

- The reimbursements to the trust resulting from the Internal Audit review initiated by the CAO in June 2002 have been made.
- The assets of the County's pension fund are secure and were never at risk. Under the County Charter the Director of Finance is custodian of these assets.
- The County's pension payments to retirees are also secure and were never at risk. They are made in accordance with the County's retirement law.

2.6.2 Ensure Reimbursement for Excessive Educational Expenses (Finding No. 21)

Certain payments made with trust funds for employee development expenses of the former director were excessive. Specifically, the BIT paid amounts in excess of annual limitations placed on expenses incurred for employee development including college tuition and seminar and conference costs relating to continuing professional education.

In 2001, the County adopted new personnel regulations which included guidelines for the payment of costs associated with employee development. Employee development expenses specified in the County's personnel regulations include various activities such as college tuition, courses by professional associations, seminars and conferences, and in-house training. Funding for some employee development activities is centralized under OHR while funding for other activities is left to the discretion of the employee's department. Beginning in FY 2002, an annual limit of \$9,000 was placed on the amount of employee development expenses that could be paid by the employee's department.

The regulations require the employee to remain employed with the County for a certain length of time following completion of the training activity or to reimburse the County a prorated portion of the expenditure. Prior to FY 2002, there was no provision for the expenditure of department funds for tuition expenses.

We reviewed financial records pertaining to expenses for employee development activities of the former director and a total of \$20,177 is questioned as follows: \$4,700 for FY 2001; and \$15,477 for FY 2002. During FY 2002, BIT paid a total of \$24,477 for employee development activities for the former director, exceeding the \$9,000 annual limit by \$15,477 (the expenditures included \$13,650 for graduate school tuition and related expenses and \$10,827 in expenses related to continuing professional education for attendance at eight seminars and conferences). The chairman of the BIT recommended, and BIT approved by resolution, the expenditure of ERS trust funds for employee development activities of the former director "consistent with County regulations" related to tuition expenses. In addition, the arrangement between the BIT and the former director was reduced to writing and signed by the CAO.

In addition, because the former director left County employment before fulfilling service requirements following completion of employee development activities, the BIT is also due \$10,882, the prorated portion of employee development expenditures made on his behalf in FY 2001, FY 2002, and FY 2003.

The BIT reports that appropriate reimbursements to the trust have been made. The reported corrective action is duly noted and the BIT is commended for causing that action to be taken. However, according to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the corrective action when we do our audit follow-up work.

In addition, there is some disagreement between the BIT and us about how much is owed the trust. The BIT maintains that employee development expenses include only college or graduate school tuition and fees and not costs associated with other employee development activities such as attendance at various professional seminars and conferences which the board suggests are "an essential part of staying current and meeting [employee] job obligations." We believe attendance at such functions by County employees, unless specifically required by the County, is neither essential nor a job obligation, but is discretionary and within the clear definition of employee development and corresponding limitations regarding departmental funding for such activities.

Recommendation:

The BIT should ensure the trust is reimbursed \$31,059 including \$20,177 for excessive educational expenses incurred by the former director and \$10,882 for the prorated portion of allowed employee development expenses attributed to the former director for not completing required service with the County. In addition the BIT should document expenditures for employee development each fiscal year and ensure the agency complies with fiscal year limitations in the future.

Agency Response:

We concur in part. Appropriate reimbursements to the trust have already been made. See our response to finding #20.

Section 14-2 of the Personnel Regulations sets a ceiling of \$9,000 per year for authorized expenditures for employee development activities. OIG's interpretation of this ceiling is that it applies not only to tuition but also to expenditures for job-related seminars and conferences. Like the Finance Department's Internal Audit Section, we have a different interpretation. We believe that participation by Board staff in selected investment seminars and conferences is not graduate school education; instead, it is an essential part of staying current and meeting their job obligations. Such forums also enable staff to undertake further due diligence work related to evaluating current and prospective investment managers.

2.6.3 Ensure Reimbursement for Improper Personal Expenses (Finding No. 22)

Certain payments made with trust funds were for personal expenses of the former director or were unnecessary business expenses. Specifically, the former director authorized the direct payment of, or requested reimbursement for, personal expenses and unnecessary business expenses incurred locally or during non-local travel events. The County has established policies for the reimbursement of necessary and reasonable expenses incurred by employees when carrying out official business for the County. Those policies are found in Administrative Procedure No. 1-2, Non-Local Travel Guidelines, and No. 1-5, Local Travel Guidelines. Policy states that only the actual, necessary, and reasonable expenses essential to conducting County business are to be reimbursed. Employees are expected to exercise good judgment in expending funds. Personal expenses of the employee are not reimbursable.

We reviewed financial records pertaining to expenses paid on behalf of the former director. The following expenses are questioned costs: non-local travel expenses \$5,482 and personal cell phone expenses \$2,524. In addition, the former director did not reimburse the BIT for non-local travel expenses paid by the trust and also paid by a third-party professional association, in the amount of \$1,164.

<u>Non-local Travel Expenses</u>. The former director traveled extensively on BIT business, taking 63 trips over five fiscal years. Expenses for the trips were paid in several ways: directly by the trust, charged to a County-issued travel and expense credit card, or paid by the former director with subsequent reimbursement by the BIT.

We reviewed available documentation for each of the travel events, including travel authorization request forms, travel expense voucher forms, expense receipts, FAMIS reports, and other BIT records. Analysis of the records identified numerous expenses paid for by the trust funds based upon the representation of the former director that the expenses were necessary and reasonable official business expenses related to non-local travel. We determined some of the expenses were unnecessary and unreasonable business expenses and others were personal in nature. The identified expenditures of \$5,482 did not qualify as legitimate, official BIT business expenses under existing County administrative procedures.

<u>Personal Cell Phone Expenses</u>. The former director was issued a BIT cell phone. The BIT received a monthly cell phone account statement which was reviewed and approved for payment by the former director. A review of cell phone use revealed a considerable number of personal calls unrelated to official BIT business placed on the cell phone. The cost of non-BIT business personal usage during FY 1999 through FY 2002 was \$2,524.

Reimbursement of Expenses Paid by Professional Association. In October 1998 the former director attended a conference in Seattle, Washington. The BIT paid for airfare in the amount of \$1,164. The following month, the conference sponsor issued a check to the former director for the cost of the airfare. The former director negotiated the check and kept the proceeds. The proceeds should have been returned to the BIT.

The BIT reports that appropriate reimbursements to the trust have been made. There may be some disagreement between the BIT and us about whether the trust has been made whole with respect to this particular finding. However, the reported corrective action is duly noted and the BIT is commended for causing that action to be taken. According to generally accepted government auditing standards, corrective action taken during an audit should not be accepted as justification for dropping a significant finding or related recommendation. We will verify the extent of the corrective action taken when we do our audit follow-up work.

Recommendation:

The BIT should ensure that the trust is reimbursed \$9,170 for personal expenses incurred by the former director of pension investments. In addition the BIT should periodically review reimbursements made to BIT personnel to ensure management controls are not compromised and to ensure all BIT personnel report and account for all expenses paid or reimbursed by trade or professional associations.

Agency Response:

We concur in part. Appropriate reimbursements to the trust have already been made. See our response to finding #20.

2.6.4 Ensure Compliance with County Ethics Law

(Finding No. 23)

The former director of pension investments did not comply fully with ethics law provisions. During a related investigation, we reviewed the financial disclosure statements filed by the former director for calendar years 1997, 1999, 2000, and 2001. Financial disclosure statements filed for calendar years 1997 and 2001 revealed outside employment with compensation. The former director had neither requested nor received authorization from the ethics commission to engage in any outside employment. Further, the statement filed for calendar year 2001 did not disclose material information the former director was required to report pertaining to debts owed by an employee.

Management controls are designed to reasonably ensure rules and regulations are followed. The County's public ethics law is an important control that provides assurance to the public that individuals charged with stewardship of significant assets such as the retirement fund trusts adhere to the highest ethical standards. Non-compliance with the ethics law weakens this very important management control and increases the risk that conflicts of interest or other information of importance to maintaining ethical standards could go undetected.

Recommendation:

The BIT should work with the Ethics Commission and the County administration to ensure full compliance with the County's public ethics law.

Agency Response:

We concur. It is essential for all departments and offices to comply fully with the County's ethics law.

2.6.5 Ensure Due Diligence and Supervision of Employees

(Finding No. 24)

The BIT did not provide adequate due diligence and supervision of the former director. The selection and appointment of the director, a sensitive fiduciary position responsible for trust assets, dictates heightened supervision of the appointee. The degree of supervision provided

may have been unintentionally compromised because the management structure overseeing BIT employees is not clearly defined. The former director reported to the CAO but was supervised in day-to-day activities by the chairman of the board, an ex-officio trustee. We noted "red flags" and missed opportunities throughout the tenure of the former director in which closer supervision might have identified ethical lapses and detected and prevented instances of fraud, waste, and abuse. The missed opportunities included the following.

Credit card abuse. The former director regularly used the County-issued travel and expense credit card to make 65 personal purchases over several fiscal years. Reimbursement to the County for the personal purchases was not made timely. Further, the former director conducted eight separate cash withdrawal transactions on the County credit card totaling \$5,950. When the cash withdrawal transactions were brought to the attention of an exofficio trustee, the former director was told not to conduct anymore cash withdrawals. Neither the board nor the CAO thoroughly reviewed the true purpose of the withdrawals or pursued the matter further.

<u>Travel expenses accounting</u>. The former director traveled extensively on BIT business and on 30 occasions obtained an advance of funds from the BIT to pay for expenses. County policy dictates that the use of advanced travel funds must be accounted for within 10 working days following the completion of the travel. On 20 occasions, the former director did not account for the advanced funds in a timely manner with some accountings several months late. Neither the board nor the CAO adequately reviewed the former director's accounting for travel expenses.

<u>Cell phone use</u>. The former director used a BIT cell phone to make many personal phone calls, often causing the monthly use to be over allotted plan minutes. When an ex-officio trustee supervisor was informed about the situation, the response was to change the cell phone plan to allow more minutes rather than to examine the nature of the use of the phone. Neither the board nor the CAO adequately reviewed the former director's cell phone use.

<u>Due diligence</u>. A background check on the former director was performed by a consultant for the BIT. The resulting report identified some but not all of the tax liens filed in the circuit court against the former director. Missed was a tax lien in the amount of \$6,387 filed while the former director was a BIT employee but before he was appointed director. While the BIT can not be held responsible for what the consultant's due diligence report did not uncover, the fact that some tax liens were disclosed certainly put the BIT on notice that the former director had financial issues in his past. Either the BIT or the CAO should have increased their supervisory scrutiny of the former director.

Appropriate supervision is one of the most basic and important management controls. Generally, senior managers adhere to the highest ethical standards and operate with autonomy and minimal direct supervision as befits their status. However, a supervisor has a duty to ensure a subordinate is acting within the bounds of acceptable behavior. The former director was supervised by the CAO but day-to-day supervision fell to the BIT chairman, an ex-officio board member. This arrangement for supervision of the former director may have

inadvertently contributed to the condition that allowed him to abuse his position of trust without detection or adequate management response for some time.

Recommendation:

The BIT should work with the CAO to clarify lines of supervision and accountability for BIT employees, especially the executive director; to conduct regular, periodic reviews of non-local travel expenditures, at least annually; and to conduct regular, periodic reviews of any credit card use, at least annually.

Agency Response:

We concur in part. We have implemented the requisite procedures for effective supervision, as outlined in the Administrative Manual of December 2002 and other Board policies and procedures.

All County employees are expected to respect County values and procedures at all times. For senior managers in particular, as the report says, the expectation is that they will "adhere to the highest ethical standards." As for "red flags," some are more clearly visible after the fact. That said, the Board's strengthened administrative procedures will help ensure effective supervision.

MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

BOARD OF INVESTMENT TRUSTEES: ADMINISTRATIVE MANAGEMENT PRACTICES

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3. OTHER ISSUE AND CONCERN

In this chapter we present an issue we observed during our fieldwork. This issue was beyond the immediate scope and objectives of our audit so we therefore did not develop it as a formal finding. However, while not fully developed as a finding, the issue is not without potential significance for the future. The BIT and the County may wish to consider it worthy of further, more in-depth study.

Retirement Savings Plan Performance

During our review of legislative histories of the various components of the three employee retirement plans we noticed that in the spring of 1994 County policy-makers engaged in a thorough discussion of the advantages and disadvantages of the County moving employees away from the ERS, a defined benefit plan, and toward the RSP, a defined contribution plan. At that time the then-County Executive stated five major goals to be achieved with the RSP: to provide a fairer and simpler retirement plan for employees; to contain employee benefit costs; to provide portability of benefits for employees leaving County employment; to provide lower paid employees with a greater replacement of their income; and to provide a framework to measure total compensation.

A legislative request report asserted, "The defined contribution plan will provide a reasonably equivalent alternative to the defined benefit plan. While the defined contribution plan will not have a formal cost-of-living increase, members will generally be protected against inflation by investment growth in their accounts." When the RSP was established in 1994, investment assumptions were based on rates of return of six and eight percent. An analysis of individual member accounts within the many investment options available to test the validity of this assertion was, as mentioned above, beyond the scope of this audit. Over time the assertion may well prove to be true for many individual RSP members. However, investment assumptions, which were used in 1994 to estimate future RSP annuities, may prove to be off the mark.

If rates of return for the RSP have lagged behind the assumptions used to launch the program, it could put the County at a competitive disadvantage when recruiting new employees, particularly older experienced employees, for non-public safety positions.

MONTGOMERY COUNTY, MARYLAND OFFICE OF INSPECTOR GENERAL

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4. CONCLUSION

The BIT manages three employee retirement trust funds with assets averaging more than \$2 billion for more than 18,000 members/participants. The BIT shares fiduciary responsibility for the administration of trust fund activities with the CAO. The BIT sees its primary responsibility as oversight of investment activities. The board believes that this alignment of responsibilities relieves it of responsibility for trust fund administrative management practices outside the narrow confines of investment management. We believe the board's interpretation of its duties and responsibilities in this restricted manner has enabled some difficulties to occur including fraud and abuse by a former senior manager and unnecessary waste in administrative operations.

After completing our audit planning, we decided to focus our attention on five topics: performance measures, fixed assets management (office equipment and computers), budget practices and administrative expense management, governance and management controls, and follow-up from prior audits. In addition we decided to report on a fraud, waste, and abuse investigation we conducted into certain activities of the former director of pension investments. We did not audit either investment management activities or the County's plan administration issues, except as they related to trust fund administrative expenditures and the need for better management controls.

During the course of this audit we found evidence of fraud, waste, and abuse. Therefore, many of our findings and recommendations are geared toward preventing similar or even more serious events in the future. <u>Independence, accountability,</u> and <u>transparency</u> became the watchwords for this audit. To the extent that we could make recommendations for the BIT to operate more independently within its current legal framework we opted to do that. Where we thought changes in the law were required, we suggested them. In order to make the retirement system more accountable to its stakeholders – both members/participants and taxpayers – we recommended changes that would enhance the "checks and balances" between the BIT and the County. In those areas where transparency of actions could be improved, we recommended appropriate changes. Our actions are in keeping with the County's vision statement and guiding principles:

Vision Statement

Helping to make Montgomery County the best place to be through efficient, effective, and responsive government that delivers quality services.

Guiding Principles

- insisting upon customer satisfaction
- ensuring high value for tax dollars
- adhering to the highest ethical standards
- appreciating diversity
- being open, accessible, and responsive
- empowering and supporting employees
- striving for continuous improvement
- working together as a team
- being accountable

The following sections comprise our concluding statements on each of the six topics in our report.

4.1 Performance Measures

Does the BIT communicate performance measures that are adequate for the purpose and reliable? Yes, but it could establish more effective benchmark effort with regard to administrative management practices without a great deal of additional effort.

Measuring performance and reporting the results to stakeholders in a readily understandable and widely accessible format is a key management responsibility. The BIT publishes a comprehensive annual financial report containing its audited financial statements. The CAFR also contains an investment section with specific investment objectives as well as actuarial and statistical information. Working through its investment consultant and its service providers the BIT presents additional information on investment performance. Some of this information, particularly information regarding the performance of RSP and DCP investment options, is available on the BIT website. What is not readily available, and would be helpful information to stakeholders, are benchmarks that would measure the BIT's performance over time and against specific peer retirement programs with respect to administrative management practices. These and other benchmarks should be published regularly in Montgomery Measures Up! and the annual operating budget.

4.2 Fixed Assets Management

Does the BIT manage trust fixed assets (office equipment and computers) efficiently and effectively? No, BIT stewardship of trust fixed assets needs significant improvement.

First of all, the BIT should assign staff to keep a record of all trust fixed assets wherever they are located and whether acquired by BIT or non-BIT staff. Staff assigned to maintain this list should be adequately supervised. This list should be updated periodically, no less than annually. Items should be added as they are purchased and deleted when they are properly disposed of. Second, the BIT should adhere to a written policy for the purchase of goods and services. This policy could be as simple as following the County's procurement regulations which the board legally does not have to do. In any event, at a minimum the executive director, under the close supervision of the board, should be required to give prior approval for the purchase of all goods and services.

The BIT agrees with us on the need for proper record-keeping for office equipment and computers and has approved administrative procedures relating to the procurement of goods. However, the board says its responsibility for monitoring office equipment, computers and other assets acquired with trust funds is limited only to those items it has acquired and does not include anything acquired by the CAO using trust funds. Problems of accountability may arise because of this bureaucratic gap.

4.3 Budget Practices and Administrative Expense Management

Are budget practices and administrative expenses using trust funds efficiently and effectively managed? No, budget practices and administrative expense management need significant improvement.

There is virtually no meaningful oversight of the budgeting process or administrative expenses relating to plan administration. As a result, trust fund expenditures for administrative operations have increased dramatically over the audit period when compared to other County expenditures. We recommended the BIT generally work more closely with County administration and County Council to provide adequate oversight. Specifically, we believe the baseline for administrative expenses should be reduced by \$334,586 initially and that expenditure increases in succeeding years should be held to a rate at or below the rate of increase for other County expenditures. We also recommended the board work with the County administration to devise appropriate methodology and record-keeping to accurately monitor the allocation of trust funds to pay salary and benefit costs for 30 County employees (11.6 work years) engaged in retirement plan administration activities.

Trustees believe the current level of oversight is adequate. The board further believes it has no authority or fiduciary duty over non-BIT expenditures even though it acknowledges legal title to the assets of the trust and repeatedly asserts in its CAFRs that it "approves and actively monitors the annual budgets for each plan." While legal responsibilities for trust activities may be divided between the BIT and the CAO, the BIT should work to ensure that the necessary checks and balances are in place.

Additionally, we identified annual savings to the trust funds of more than \$115,620 relating to staff reductions and reductions in data service lease payments. We also identified \$96,208 in trust funds that should be recouped to make the trust whole as a result of past office lease overpayments and suggested a renegotiation of the lease going forward in order to save an

additional \$292,402 over the remaining term of the lease. The board says that it will implement staff reductions and will reduce payments for the data service. However, it does not agree that the amount of office space it leased is unreasonable. We compared the board's office space with County space allocation guidelines. In our opinion the decision to lease the office space was not in the best interest of the trust, and, if not renegotiated, will result in eventual waste to the trust funds in the amount noted above.

4.4 Governance and Management Controls

Are governance and management controls effective? In our opinion the BIT could easily establish more effective governance and management controls without a great deal of additional effort or expense.

The responsibility for effective governance and management controls rests with the BIT. When we did our fieldwork we saw instances or events where good business practices were not being followed to the fullest extent possible. For example, all funds were not being transmitted to the trust promptly, and contract administration and preparation of the CAFR needed improvement. We recommended improvements in those specific areas. We also proposed three changes in the way the BIT operates that we believe will enhance overall governance and management control: adding a full-time accountant to the staff, assuming greater responsibility for staff and consultants, and increasing the number of independent trustees by one.

In our efforts to enhance governance and management controls with respect to BIT administrative management practices we referenced recent governance scandals in the private and public sectors and the remedial nature of various provisions of Sarbanes-Oxley and ERISA. The BIT believes that the scandals we mentioned are irrelevant to its operations and correctly pointed out that these federal laws do not apply to its operations. These comments miss the point. Our recommendations are meant to be preventative in nature and the extent to which the BIT can voluntarily adopt stronger management controls as its own best practices, the better prepared it will be to prevent additional problems from occurring in the future.

4.5 Follow-up from Prior Audits

Has the BIT effectively followed up on findings and implemented recommendations from prior audits and other evaluations? Follow-up on findings and recommendations from prior audits and other evaluations could be better. In addition, a stronger, more consistent audit and compliance review program could be beneficial.

When we reviewed the implementation status of recommendations from prior audits we found the BIT reported it had had fully or substantially implemented seven of 12 recommendations (58.3 percent), taken some steps to implement two of the 12 recommendations (16.7 percent) including a reportable condition, and had minimally or not at all implemented three of the 12 recommendations (25.0 percent). The limited number of meetings of the full board may contribute to the delay in resolving these items. An audit committee could focus

more timely on implementation follow-up. We recommended the establishment of an audit committee composed primarily of independent trustees and an audit and compliance review program (a previous audit had also made a similar recommendation). We also pointed out areas that we thought deserved more regular independent audit scrutiny and were not getting it: invoices, disbursements, fee charges, retirement databases, pension benefit calculations, benefits payments, lump sum distributions, and member address verification. Our recommendations are reasonable in scope and would promote greater accountability.

4.6 Fraud, Waste, and Abuse Investigation

Our investigation of the activities of the former director of pension investments showed sufficient, credible, and relevant evidence that fraud, waste, and abuse had occurred. We identified a pattern of behavior by the former director that constituted a breach of the public trust, hurt BIT operations financially, and eroded public trust and confidence. We informed the chairman of the BIT and the CAO of our findings and referred the matter to the state's attorney. The CAO acted decisively and the employment of the former director was ended. We also concluded that the supervision of the former director was not sufficiently attuned to the "red flags" of improper behavior exhibited by the former director. Supervisory adherence to existing management controls could have identified, addressed, and prevented some of the fraud, waste, and abuse that occurred. The BIT generally agrees with our recommendations concerning the investigation.

4.7 Closing

We hope this report will be the impetus for some constructive changes that will make the BIT more independent with regard to its administrative management practices; make the BIT and others more accountable to stakeholders for actions using retirement trust funds; and make the actions of all involved parties more transparent to the public. In addition, we strongly believe the full implementation of our recommendations will save retirement system members/participants and County taxpayers money.

It is OIG policy to follow-up on as many of our audits, investigations, and other major projects including this performance audit as time and other resources permit.

Finally, we want to express our thanks to the trustees and staff of the BIT who were receptive to the performance audit process and responsive to OIG requests for interviews, documents, access to facilities, and other requests throughout the performance audit process.